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Department
of the
Treasury
**Internal
Revenue
Service**

Your Federal Income Tax

For Individuals

For use in preparing
1988 Returns

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The Federal Budget ***(Inside back cover)***
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The explanations and examples in this book reflect the interpretation by the Internal Revenue Service of

- Tax laws enacted by Congress,
- Treasury regulations, and
- Court decisions.

However, the information given does not cover every situation and is not intended to replace the law or change its meaning.

This book covers some subjects on which a court may have made a decision more favorable to taxpayers than the interpretation of the Service. Until these differing interpretations are resolved by higher court decisions or in some other way, this book will continue to present the interpretation of the Service.

All taxpayers have appeal rights within the Service and may appeal to the courts when they do not agree with the interpretation of the Service. Appeal procedures are described in *The Examination and Appeals Process*, in the back of this book.

All material in this book may be reprinted freely. A citation to *Your Federal Income Tax (Rev. Nov. 88)* would be appropriate.

Introduction

This book can help you prepare your own tax return by taking you step by step through each part of the return. It explains the tax law in plain language, and will help you better understand your taxes so that you pay only as much tax as you owe and no more.

The book begins with the rules for filing a tax return. It explains who must file a return, which tax form to use, when the return is due, and other general information. It will help you decide which filing status you qualify for, whether you can claim any dependents, and whether the income you are receiving is taxable. The publication goes on to explain the standard deduction, the kinds of expenses you may be able to deduct (like medical expenses, donations to charities, etc.), and the various kinds of credits you may be able to take to reduce your tax.

Throughout the book are examples showing how the tax law applies in typical situations. Sample forms and schedules show you how to fill out your return.

The index in the back of the book will help you find the information you need as quickly as possible. Also in the back are lists of free tax help available to you, including other publications, tape recorded information, materials that are available in Spanish, and where to call to get further assistance.

You can get free IRS publications by calling 1–800–424–FORM (3676) or by using the order form in the back of this book. Many public libraries also have reference sets of these publications that you can use.

We welcome your suggestions for future editions of this book. Please send your ideas to:

Internal Revenue Service
Technical Publications Branch (TR:FP:P)
1111 Constitution Ave., NW
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your area code and daytime phone number along with your return address.

Important Changes for 1988

This section summarizes important tax law changes that took effect since this publication was last revised. These changes are discussed in more detail throughout this publication.

Pending legislation. As this publication was being prepared for print, Congress was considering legislation that could affect items on your 1988 income tax return. These proposed changes are discussed in the chapters of this publication.

In addition, this legislation includes changes that could also affect the amount of your estimated tax for 1989. If this legislation is enacted, you may need to adjust your withholding or estimated tax payments to avoid owing a penalty for underpayment of estimated tax. See Chapter 5 for highlights of the items that may be changed. These 1989 changes are also discussed in Publication 553, *Highlights of 1988 Tax Changes*, along with changes that may take effect for 1988.

Supplemental Medicare premium. Beginning in 1989, you may owe a supplemental Medicare premium if you are eligible to receive hospital insurance benefits under Medicare Part A. You will owe the premium for 1989 if you are Medicare eligible (without paying a monthly premium) for more than 6 full months during the year and your income tax is $150 or more. Your premium will be used to help pay the cost of the new Medicare coverage for catastrophic expenses.

If you owe a supplemental Medicare premium for 1989, you must add it to the tax shown on your 1989 income tax return, and pay it in the same way you pay your income tax. The premium is not deductible. You should increase your income tax withholding or estimated tax payments for 1989 to include the amount of your supplemental Medicare premium. By doing this, you will avoid having to pay it all at one time. See Chapter 5.

Filing requirements. Generally, the amount of income you can have before you are required to file a return has been increased. See Chapter 1.

Dependent's filing requirements. A dependent generally must file an income tax return if the dependent has:

- Earned income ***only,*** and the total is more than $3,000,
- Unearned income ***only,*** and the total is more than $500, or
- ***Both*** earned and unearned income, and the total is more than $500.

These amounts are different if the dependent is married, age 65 or older, or blind. See Chapter 1.

New tax rates for 1988. The Tax Reform Act of 1986 lowered the tax rates and changed the tax rate structure.

For tax years beginning in 1988, the two basic tax rates are 15% and 28%. However, if your taxable income is more than $35,950, your tax may be adjusted to phase out the benefit of the 15% tax rate. The benefit of the 15% tax rate is phased out by increasing your tax by 5% of part of your taxable income. This could result in the application of a 33% rate to part of your taxable income. See Chapter 31.

If your taxable income is more than $89,560, your tax may also be adjusted to phase out the benefit of your exemptions. The phaseout of exemptions is figured on a worksheet in the Tax Rate Schedules. See Chapter 3.

Higher exemption amount. For 1988, you are allowed a $1,950 deduction for each exemption to which you are entitled.

Exemption phaseout. Beginning in 1988, you may lose the benefit of part or all of your exemptions if you have taxable income of more than $89,560. See Chapter 3.

Standard deduction. For most taxpayers, the standard deduction is higher in 1988 than it was in 1987. The amount generally depends on your filing status, and whether you are age 65 or older or blind. This increased benefit reduces the need for many taxpayers to itemize their deductions. See Chapter 22.

Higher standard deduction for age and blindness. If you are age 65 or older or blind at the end of 1988, you may be entitled to a higher standard deduction amount. Chapter 22 has the higher amounts. However, your standard deduction amount remains the same as for 1987 if you qualified for the higher amounts last year.

Earned income credit. If your earned income and your adjusted gross income are both less than $18,576 and you have a child who lived with you for more than half the year, you may be entitled to a refundable credit of up to $874. See Chapter 35.

Child and dependent care credit. Beginning in 1988, you can no longer include the expenses of sending your child or other dependent to an overnight camp when figuring this credit. See Chapter 33.

Capital gains holding period. If you purchased a capital asset after 1987, you will have long-term capital gain or loss on the sale or other disposition of the asset only if you hold it for more than one year. If you hold a capital asset purchased after 1987 for one year or less, your capital gain or loss is short term. See Chapter 16.

Tax on capital gains. Beginning in 1988, your capital gain income is taxed at the same rates as your ordinary income. See Chapter 9.

Standard mileage rate. For 1988, the standard mileage rate for the first 15,000 miles of business use of a car is 24 cents a mile. Using the standard mileage rate, depreciation is considered to be allowed at the rate of 10.5 cents per mile. See Chapter 19.

Pension and annuity distributions. Several changes regarding pensions take effect in 1988. Some of these changes are listed below:

- **Simplified method for figuring** the tax-free amount of your pension under the General Rule. If your annuity starting date is after July 1, 1986, beginning in 1988 you may be able to use a simplified method of figuring the tax-free amount of your pension.
- **Capital gain treatment of lump-sum distributions.** Beginning in 1988, the capital gain treatment of lump-sum distributions you receive from pension plans will be phased out, unless you were born on or before January 1, 1936.
- **Tax on excess distributions.** The amount of retirement distributions that may be made to you during the year without incurring the tax on excess distributions has been increased to $117,529 for 1988 (from $112,500 that applied for 1987).
- **Tax on excess accumulations (failure to make minimum distributions).** For tax years beginning ***after 1988,*** a 50% excise tax will apply to required minimum distributions that are not made during the year. Generally, you must begin receiving distributions from your pension plan by April 1 of the year following the calendar year in which you reach age 70½.

- **For more information** on pensions and annuities, see Chapter 11.

Interest. Recent legislation changed the rules concerning the home mortgage interest deduction and provided for the gradual elimination of the deduction for personal interest expense. Changes for 1988 include:

- **Personal interest.** Personal interest, such as interest on car loans, credit cards, and personal loans, is not fully deductible. You can deduct only 40% of the personal interest you paid in 1988. See Chapter 25.
- **Mortgage interest.** Beginning in 1988, the rules for the home mortgage interest deduction have changed. Generally, if you got a loan ***before October 14, 1987***, that was secured by your main or second home, you can deduct all of the interest.

  If you got a loan ***after October 13, 1987***, that was secured by your main or second home and you used the funds to buy, build, or improve that home, you can deduct all of the interest if the loan is $1 million or less. You can also deduct all of the interest on an additional $100,000 of loans secured by your main or second home. See Chapter 25.

Educational assistance program. Beginning in 1988, you may have to include in income all educational assistance payments provided to you by your employer under an educational assistance plan. You may no longer be able to exclude the first $5,250 of benefits. See Chapter 6.

However, you may still be able to deduct certain educational expenses. See Chapter 29.

Group legal services plan. Beginning in 1988, you may have to include in income amounts paid by your employer on your behalf for a qualified group legal services plan. You may also have to include the value of benefits you received under the plan. See Publication 553.

Allocated expenses of a mutual fund. Allocated investment expenses of a mutual fund are deductible as an itemized deduction. However, beginning in 1988, you may be able to deduct only the part that, when combined with certain other miscellaneous deductions, is more than 2% of your adjusted gross income. See Chapter 30.

Credit for prior year minimum tax. Beginning in 1988, you may be able to take a minimum tax credit against your regular income tax if you paid alternative minimum tax the year before. See Chapter 35.

Employee reimbursements. Recent legislation is changing the way you deduct your reimbursed employee business expenses. Beginning in 1989, in order to deduct reimbursed employee business expenses as an adjustment to income, you must adequately account to your employer and your employer must not allow you to keep excess reimbursements. See Chapter 19.

Residential energy credit carryforward. If you had any unused residential energy credit from prior years, you can no longer deduct it beginning in 1988. (The residential energy credit was available only for energy saving or renewable source property installed in your home before 1986.)

Qualifying widows and widowers. For tax years beginning in 1988, if you are a qualifying widow or widower with a dependent child, you may have a choice of filing Form 1040A or Form 1040. For tax years before 1988, qualifying widows and widowers could only file Form 1040. See Chapters 1 and 2.

Electronic filing. If you are due a refund on your 1988 federal income tax return, you may be able to have it filed electronically. The Internal Revenue Service is accepting electronically filed returns in 36 states for the 1989 filing season.

Electronic filing is a method by which qualified professional tax preparers send tax return information over telephone lines directly to an Internal Revenue Service Center. You cannot have your return filed electronically if you have a balance due.

If you have your tax return filed electronically by a qualified tax preparer:

- Your income tax refund will be processed faster,
- Your tax preparer will be notified by the IRS that your return was accepted, and
- You can choose to have your refund deposited directly into your savings or checking account.

For a list of qualified tax preparers in your area, call toll free 1-800-424-1040 and ask for the Electronic Filing Coordinator. For more information on electronic filing, dial the Tele-Tax number for your area and ask for topic number 112 (Tele-Tax information is near the back of this publication).

Changes in Service Centers. If you live in one of the states listed below, you must file your tax return in a Service Center that may be different from where you filed last year.

If you live in:

- Alabama — file with the Memphis Service Center,
- Indiana — file with the Cincinnati Service Center,
- Louisiana — file with the Memphis Service Center,
- Minnesota — file with the Kansas City Service Center,
- Mississippi — file with the Memphis Service Center, and
- Virginia — file with the Philadelphia Service Center.

The addresses of the Internal Revenue Service Centers are listed on the back cover of this publication.

New publication. If you want to know about many of your rights as a taxpayer, get Publication 1, *Your Rights As A Taxpayer*, a new and easy-to-read publication available from the Internal Revenue Service. It explains many of the rights you have when you deal with the IRS. If you know your rights, you will know if you have received the quality of service you are entitled to as a taxpayer. See the back of this publication for information on how to get your copy.

User fees. The Internal Revenue Service, through its Office of Chief Counsel, provides technical advice on several types of complicated tax matters. Under the Revenue Act of 1987, the IRS must charge a fee for these services. For information on the fees and services available, see Publication 538, *Accounting Periods and Methods*.

Important Reminders

Listed below are important reminders and other items that may be of help to you in filling out your tax return and understanding the tax laws. Most of these items are explained in more detail later in this publication.

Summary of Tax Reform Act of 1986 changes. In addition to provisions discussed earlier under *Important Changes for 1988*, the Tax Reform Act of 1986 made numerous other changes to the tax law. Many of these other changes took effect in 1986 or 1987. These changes affected items such as exemptions, estimated tax, personal interest deductions, mortgage interest deductions, filing requirements for dependents, and individual retirement arrangements (IRAs).

These and other changes in the tax law that took effect before 1988 are noted below.

For more detailed information on changes that took effect in 1988 and some changes that will take effect in later years, see Publication 553, *Highlights of 1988 Tax Changes*.

Repealed items. The Tax Reform Act of 1986 repealed several provisions of prior tax law. These include:

- Regular investment credit.
- 3–year rule for tax-free recovery of contributions to employee annuities starting after July 1, 1986.
- $1,000-a year exclusion of interest on installment proceeds of life insurance. This is for amounts received by a surviving spouse for deaths occurring after October 22, 1986.
- Income averaging.
- Dividend exclusion.
- 60% deduction for capital gains.
- Deduction for state and local sales taxes.
- Deduction for qualified adoption expenses.
- Deduction for a married couple when both work.
- Credit for political contributions.
- Extra exemptions for age and blindness. These exemptions have been replaced by a higher standard deduction for taxpayers who are 65 or older or blind.

Provisions that affect dependents. Several provisions of the Tax Reform Act of 1986 affect dependents. Some of these provisions are listed below.

- Many dependents, including children, who had never filed tax returns now have to file returns and pay tax.
- No personal exemption is allowed a taxpayer who can be claimed as a dependent by another taxpayer.

- The standard deduction for an individual who can be claimed as a dependent on another taxpayer's return generally is limited.

Who must file an income tax return. Whether you must file an income tax return depends on your gross income, filing status, age, and whether you are blind (if you are a dependent). The filing requirements for tax years beginning after 1986 have changed. Generally, the Tax Reform Act raised the amount of income you can have before you are required to file a return. This means fewer people have to file returns. See Chapter 1.

Exemption for dependent. If you can claim an exemption for a dependent on your tax return, that dependent cannot claim a personal exemption on his or her own tax return. See Chapter 3.

Dependents' social security numbers. You must list on your Form 1040 or Form 1040A the social security number of any dependent you claim who is age 5 or older at the end of 1988 (***age 2 or older at the end of 1989***). See Chapter 3.

Estimated tax. Several changes to the tax laws affect who should make estimated tax payments and the penalty for underpayment of estimated tax.

- **Who should make estimated tax payments.** You must make estimated tax payments if you will owe $500 or more in estimated tax for the year and the total amount of income tax that will be withheld from your income for the year will be less than the smaller of: 1) 90% of the tax shown on your return for the year, or 2) 100% of the tax shown on your tax return for the previous year. See Chapter 5.
- **Penalty for underpayment of estimated tax.** The penalty rate for underpayment of estimated tax is determined every calendar quarter. Also, the penalty rate for April 1 through April 15 is the same as the penalty rate for January through March. See Chapter 5.

Reporting tax-exempt interest. You must show on your tax return the amount of any tax-exempt interest you received or accrued during the tax year. This is an information-reporting requirement and does not change tax-exempt interest to taxable interest. See Chapter 8.

Repeal of dividend exclusion. This exclusion is no longer allowable. You must now report the entire amount of your ordinary dividends as taxable income.

Unemployment compensation. You must include in income all unemployment compensation you receive. See Chapter 6.

Dependent care assistance. You can exclude up to $5,000 ($2,500 if you are married filing a separate return) from income for dependent care assistance provided by your employer. If your dependent is cared for at your employer's place of business, the amount that you can exclude from income will be based on your use of the facility and the value of the services. See Chapter 6.

Interest on frozen deposits. In general, you can exclude from income the amount of interest earned on a frozen deposit. A deposit is frozen if, at the end of the calendar year, you cannot withdraw any part of the deposit because: (1) the financial institution is bankrupt or insolvent; or (2) the state where the financial institution is located has placed limits on withdrawals because other banks in the state are bankrupt or insolvent. See Chapter 8.

Interest on life insurance proceeds for a surviving spouse. If you get insurance proceeds because of the death of your spouse who died before October 23, 1986, and you receive the proceeds in installments, you can exclude up to $1,000 a year of the interest included in the installments. This exclusion, however, is not allowed for amounts you receive if your spouse died after October 22, 1986. See Chapter 8.

Employee achievement awards. You can exclude employee achievement awards from income only if they are deductible by your employer. See Chapter 13.

Year-end sale of securities. If you sell securities on an established securities exchange, you must recognize your gain or loss on your trade date, not on your settlement date. This rule applies even if the trade date and the settlement date are in different years. See Chapter 16.

Pensions and annuities. The Tax Reform Act of 1986 made many changes that could affect persons who receive pension or annuity payments.

- **Three-Year Rule and General Rule.** If you are receiving a pension or annuity with an annuity starting date after July 1, 1986, you cannot use the Three-Year Rule to figure the tax on your pension or annuity. You must use the General Rule. In addition, if your annuity starting date is after 1986, your total exclusion over the years cannot be more than your total cost reduced by the value of any refund feature. See Chapter 11.
- **Tax on early or excess pension distributions.** To help ensure that pension savings are in fact used for retirement, penalty taxes apply to early and excess distributions of pensions.
- **Averaging treatment of lump-sum distributions.** The former 10–year averaging treatment for distributions has been changed to 5–year averaging. See Chapter 11.

Scholarships and fellowships. If you receive a scholarship or fellowship that was granted after August 16, 1986, you may have to include part of it in your gross income. A taxable scholarship is generally treated as unearned income. However, it is treated as earned income for your filing requirements and standard deduction. See Chapters 1, 13, and 22.

Not-for-profit business or investment. In determining whether a business or investment is carried on to make a profit, all the factors surrounding the activity are taken into account. There is, however, a presumption that the activity is carried on to make a profit if, beginning in 1987, it produces a profit in at least 3 out of 5 consecutive years. Before 1987, the presumption was met if the activity produced a profit in 2 out of 5 years. See Chapter 13.

Passive activity losses and credits. A passive activity generally is any activity involving the conduct of a trade or business in which you are not involved on a regular, continuous, and substantial basis. In addition, any rental activity is a passive activity.

Generally, you can only offset losses from passive activities with income from passive activities. Also, you can generally use credits from passive activities only to offset taxes on income from passive activities. There are exceptions for certain passive activites, such as rental real estate activities. There are also phase-in rules for some losses from passive activities.

See Chapters 8, 9, 10, and 14.

Employee business expenses. To deduct any unreimbursed employee business expenses, you must itemize your deductions on Schedule A (Form 1040). Reimbursed employee business expenses are claimed as an adjustment to income if the reimbursement is included in income.

You claim unreimbursed employee business expenses as a miscellaneous itemized deduction. Generally, you can deduct only the part of your miscellaneous deductions that is more than 2% of your adjusted gross income. See Chapter 19.

Limit on meals and entertainment. You can deduct only 80% of your business-related meal and entertainment expenses unless the expenses meet certain exceptions. For employees, this 80% limit applies in addition to the 2% of adjusted gross income limit on unreimbursed employee business expenses. See Chapter 19.

Outside salespersons. If you are an outside salesperson, your expenses are subject to the same rules that apply to other employees. You must deduct the unreimbursed expenses of performing your job on Schedule A (Form 1040) rather than as an adjustment to income. See Chapter 19.

Investment travel. You are not allowed a deduction for travel or other costs of attending a convention, seminar, or similar meeting that is related to investment activities and not related to your trade or business. See Chapter 19.

Depreciation. The Tax Reform Act of 1986 made substantial changes to the depreciation rules. The major changes that affect individual taxpayers are those that apply to automobiles used in business and to rental property.

- **Automobiles.** Generally, under prior law, you could recover the cost of an automobile over 3 years. However, if you place an automobile in service after 1986, you recover its cost over 5 years. In addition, your maximum deduction is limited. The total depreciation and section 179 deduction for an automobile cannot exceed $2,560 for the first year of the recovery period. See Chapter 19.
- **Rental property.** If you place a rental house in service after 1986, you recover its cost over 27.5 years. Also, you use the straight line method to figure your depreciation deduction. See Chapter 10.

IRAs. The Tax Reform Act of 1986 made major changes to the tax treatment of individual retirement arrangements (IRAs). Some of these changes are discussed below. See Chapter 20 for more details.

- **Deductible contributions.** If you are a moderate to high-income taxpayer who is covered by an employer retirement plan, you may be able to take a full, partial, or no deduction, depending on your filing status and your adjusted gross income.

- **Nondeductible contributions.** You can make nondeductible contributions to your IRA, even though your deductible IRA contributions are reduced or eliminated.
- **Penalty.** You will be charged a $100 penalty if you overstate the amount of your nondeductible IRA contributions.
- **Spousal IRA.** You can set up a spousal IRA if your spouse has no compensation for the year or your spouse chooses to be treated as having no compensation for the year.
- **Salary reduction arrangements.** A simplified employee pension (SEP) may include a salary reduction arrangement. Under this arrangement, you can choose to have your employer make contributions to the SEP out of your salary.
- **Employer SEP contributions.** You do not include your employer's SEP contributions in your income. However, since you do not need to include the contributions in your income, you cannot deduct them.
- **Distributions.** You may have to pay an additional tax of 10% on early withdrawals.
- **Required distributions.** Distributions from your IRA must begin no later than April 1 following the year in which you reach age 70½. Required distributions for 1988 must have been made by December 31, 1988. If you reached age 70½ in 1988, distributions from your IRA do not have to begin until April 1, 1989.

Alimony. The Tax Reform Act of 1986 changed the extent to which large payments you make during the first 2 years of divorce can qualify as alimony. These rules generally apply to payments made under divorce or separation instruments entered into or modified after 1986.

You may be able to deduct alimony payments even if your instrument does not specifically state that the payment of alimony (or separate maintenance) stops upon the death of your spouse or former spouse. See Chapter 21.

Self-employed health insurance premiums. If you were self-employed in 1988, you may be able to deduct up to 25% of your health insurance premiums from your gross income. You include the rest of your health insurance premiums as medical expenses in figuring your medical and dental expenses. See Chapter 23.

Repeal of deduction for married couples when both work. This deduction (also known as the two-earner deduction) is no longer allowed.

Medical and dental expenses. You can only deduct the part of your medical and dental expenses that is more than 7.5% of your adjusted gross income. See Chapter 23.

State and local sales taxes. You cannot deduct state and local sales taxes. Any sales tax you pay on the purchase of an asset is added to the basis of the asset to figure its cost for purposes of depreciation, casualties, and gain or loss on disposition. See Chapters 15 and 24.

Charitable contributions. You can claim charitable contributions only as an itemized deduction on Schedule A (Form 1040). You cannot deduct charitable contributions if you file Form 1040A or Form 1040EZ. See Chapter 26.

Casualty losses. You cannot deduct a casualty or theft loss that is covered by insurance unless you filed a timely insurance claim for reimbursement. However, even if you did not file an insurance claim, you can deduct the part of the loss not covered by insurance. See Chapter 27.

Losses on deposits. You can generally claim a casualty loss for any tax year in which you can reasonably estimate a loss on deposits in an insolvent or bankrupt bank, credit union, or other qualified financial institution. You cannot claim a casualty loss for losses on deposits if you are a 1% or more owner or an officer of the financial institution or a relative of such an owner or officer. See Chapter 27.

Moving expenses. You can deduct moving expenses only as an itemized deduction on Schedule A (Form 1040). They are not subject to the 2% of adjusted gross income limit that applies to certain miscellaneous deductions. Also, you can deduct only 80% of your unreimbursed meals that qualify as moving expenses. See Chapter 28.

Travel as education. You cannot deduct the cost of travel that in itself constitutes a form of education. See Chapter 29.

Use of your home in your work. The expenses that you can deduct for the business use of your home are limited. These deductions cannot create a business loss or increase a net loss from a business.

You can carry forward to later years any deductions that would otherwise create or increase a loss. See Chapter 30.

Miscellaneous deductions. You can deduct most miscellaneous itemized deductions only to the extent that they are more than 2% of your adjusted gross income. See Chapter 30.

Adoption expenses. You cannot deduct expenses you paid to adopt a child with special needs. See Chapter 30.

Alternative minimum tax. The Tax Reform Act of 1986 increased the alternative minimum tax rate to 21% and changed the method for computing alternative minimum taxable income. The law also changed the items that are subject to this tax. Also, the exemption amount is phased out for high-income taxpayers. See Chapter 31.

Tax on investment income of certain minor children. Part of a child's investment income may be taxed at the parents' tax rate. This rule only applies if the child is under age 14 and has over $1,000 of investment income. See Chapter 32.

Income averaging. Income averaging is no longer allowed.

Credit for political contributions. You can no longer claim a credit for contributions to political candidates, campaign committees, or newsletter funds.

Other important reminders. Important reminders and other items that may be of interest to you are noted below. Most of these items are explained in more detail later in this publication.

Penalties and interest. If you underpay your taxes or file your return late, you may be charged penalties and interest. See Chapter 1.

Presidential election campaign fund. You may have $1 of your tax ($2 if married filing jointly) go to a general fund established by Congress to support public funding of the presidential election campaigns. See Chapter 1.

Gift to reduce America's debt. You can make a voluntary contribution to reduce America's debt. To do so, enclose a separate check, payable to *Bureau of the Public Debt*, with your 1988 income tax return. See Chapter 1.

File on time — even if you cannot pay. If you do not have the money to pay the amount you owe on your return, you should file your return on time and pay what you can. The Internal Revenue Service will bill you for the balance due, plus interest if the balance is not paid by the due date. You may also have to pay a failure-to-pay penalty.

If you do not file your return by the due date, you will have to pay interest on the amount you owe and you may have to pay a failure-to-pay penalty plus interest on the penalty. You may also have to pay a failure-to-file penalty, plus interest. See Chapter 1.

Records and receipts. Do not send in records, receipts, or cancelled checks with your tax return. Keep your records available so that you can produce them if the amounts you claim on your return are ever questioned.

Records that support items of income or deductions on a return should be kept at least until the statute of limitations on the return runs out.

Records that relate to the basis of property should be kept as long as they are important in figuring the basis of the property. See Chapter 1.

Copies of returns. You are encouraged to keep a copy of your tax return. A copy may be helpful in amending a filed return or preparing future returns. You can obtain a copy of a prior year tax return or a transcript of tax account information from the Internal Revenue Service. See Chapter 1.

Amended return. If you file your income tax return and later become aware of any changes you must make to income, deductions, or credits, you can file an amended return. File Form 1040X, *Amended U.S. Individual Income Tax Return*, to change the Form 1040, 1040A, or 1040EZ you already filed. See Chapter 1.

Substitute tax forms. You cannot use your own version of a tax form unless it meets the requirements contained in **Publication 1167** for acceptable privately designed and printed substitute tax forms. You can get Publication 1167 by writing to:

Forms Distribution Center
P.O. Box 25866
Richmond, VA 23289.

Head of household filing status. If you are unmarried or live apart from your spouse and you keep up a home for your child, your parents, or certain other relatives, you may be able to file as head of household. If you can file as head of household, you can use tax rates that are lower than the rates for single or married filing separately. See Chapter 2.

Signing a joint return. If you file a joint return, both you and your spouse must sign the return, even if only one of you had income. See Chapter 2.

Exemption for child of divorced or separated parents. Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents,* can be used by a custodial parent to release the child's dependency exemption to a noncustodial parent. A noncustodial parent claiming a child's exemption based on Form 8332 must attach a copy of the form to his or her tax return each year the exemption is claimed.

You do not need Form 8332 if a divorce decree or written agreement executed before 1985 states that you are entitled to claim your child's exemption, and you paid at least $600 for the child's support.

See Chapter 3.

Death of taxpayer. If a taxpayer died before filing a required return for 1988, the taxpayer's personal representative (and spouse, in the case of a joint return) must file and sign a return for that person. A personal representative can be an executor, administrator, or anyone who is in charge of the taxpayer's property. See Chapter 4.

Form W–2. You should receive your 1988 Form W–2, *Wage and Tax Statement,* by January 31, 1989. If you have not received your Form W–2 by January 31, ask your employer for it. If you do not receive it by February 15, call the toll-free number for your area listed near the end of this publication. See Chapter 5.

Income not subject to income tax withholding. If you expect to receive income not subject to income tax withholding, such as interest, dividends, capital gains, or alimony, you may have to make estimated tax payments for 1989. If you do not pay enough estimated tax or do not have enough tax withheld, you may have to pay a penalty. See Chapter 5.

Retirees. If you are a U.S. citizen or resident, the payer of your pension or annuity generally will withhold income tax from the payments you receive unless you notify the payer that you do not want tax withheld. If you do not have tax withheld, you may have to pay estimated tax. See Chapter 5.

A U.S. citizen whose residence address is in a foreign country cannot choose exemption from withholding on pension or annuity payments.

Do you want more or less tax withheld in 1989? If your refund is large this year and you want to have less tax withheld from your pay, you should get Form W–4, *Employee's Withholding Allowance Certificate,* from your employer. Complete Form W–4 claiming any additional allowance you are entitled to, and return the form to your employer. If you owe tax this year, you may need to give your employer a completed Form W–4 claiming fewer allowances. See Chapter 5.

Fringe benefits. If your employer provides you with a car, your personal use of the car may be a taxable fringe benefit. See Chapter 6 for information on other fringe benefits you may have received.

Recordkeeping for tips. You must keep a daily record or other evidence to substantiate the tip income you receive. See *Records and Reports* in Chapter 7.

Interest income. Interest income from a savings account opened for a child or minor but placed in the name, and subject to the order, of the parents as trustees may be taxable either to the child (under certain conditions) or to the parents. See Chapter 8.

State and local income tax refunds. If you received a state or local income tax refund of $10 or more in 1988, you may receive Form 1099–G, *Statement for Recipients of Certain Government Payments,* from the payer of the refund by February 1, 1989. A copy of the Form 1099–G will be sent to IRS. The refund may be taxable if you deducted the state or local income tax in a prior year. See Chapter 13.

Tax shelter registration number. A person who sells (or otherwise transfers) to you an interest in a tax shelter must maintain a list of investors and must give you the tax shelter registration number assigned to it. If you include on your tax return any deduction, loss, credit, other tax benefit, or any income from an interest in a tax shelter required to be registered, you must complete Form 8271, *Investor Reporting of Tax Shelter Registration Number,* and attach it to your tax return. Penalties are provided if you do not include this number with your tax return. See Chapter 14.

Recordkeeping for certain trade or business expenses. You must have adequate records or sufficient evidence to prove your deductions for travel, entertainment, and business gift expenses.

You must keep similar records to substantiate expenses for local transportation and business use of vehicles. See Chapter 19.

Itemizing deductions. You may benefit by itemizing your deductions if the total of your itemized deductions is more than your standard deduction amount. If your spouse itemizes deductions on a separate return, you should itemize your deductions because you will not qualify for a standard deduction. See Chapter 22.

Medicines. Amounts you paid for insulin or for medicines that required a prescription are medical expenses. See Chapter 23.

Medical expenses of a child of divorced or separated parents. A child of divorced or separated parents or of parents who live apart during the last 6 months of the year is treated as a dependent of both parents for the medical expense deduction if the child receives more than half of his or her support from the parents. Thus, a parent can deduct medical expenses he or she paid for the child even though an exemption for the child is claimed by the other parent. This special rule does not apply if more than half of the child's support is treated as received from a person under a multiple support agreement. See Chapters 3 and 23.

Refinancing costs. Generally, points you pay in refinancing a mortgage are not deductible in full in the year you pay them even if the new mortgage is secured by your main home. See Chapter 25.

Mortgage interest statement. If you paid interest of $600 or more during the year on any one mortgage to a mortgage holder in the course of that holder's trade or business, you should receive a Form 1098, *Mortgage Interest Statement,* or other statement. The statement shows the total interest you paid on the mortgage. See Chapter 25.

Charitable contributions. You may include some amounts other than cash among your allowable charitable contributions deduction. For example, unreimbursed out-of-pocket expenses directly related to services you give to a charitable organization, such as the cost and upkeep of special uniforms or the cost of gas and oil for your car, are allowable contributions. Auto expenses can be figured at 12 cents a mile if you do not want to deduct your actual expenses. You must keep certain written records to support the claimed deduction. If your noncash contributions total more than $500, you must attach Form 8283 to your Form 1040. See Chapter 26.

Moving expenses. If you changed job locations last year or started a new job, you may be able to deduct some of your moving expenses. If your move was within or to the United States or its possessions, you must report your expenses on Form 3903, *Moving Expenses.* Form 3903 must be attached to Form 1040. You cannot deduct moving expenses on Form 1040A or Form 1040EZ. See Chapter 28.

Education expenses. You may deduct expenses you have for education (even though the education may lead to a degree) only if the education maintains or improves skills required in your present work or is required by your employer, or by law or regulations to keep your salary, status, or job, if the requirements serve a business purpose of your employer. See Chapter 29.

Use of your home in your work. If you are an employee and you use a part of your home regularly and exclusively for your work as an employee, you may be able to deduct a part of the operating and depreciation expenses on your home. See Chapter 30.

Work clothes and special equipment. You may be able to deduct the cost and upkeep of special equipment or workclothes if they are required as a condition of your employment and are not suitable for everyday use. To qualify for the deduction, both conditions must be met. For example, you can deduct the cost of protective clothing, such as hard hats or safety shoes, required in your work. The cost of business suits or standard work shoes, however, is not deductible, even if your employer requires you to wear them.

The qualifying expenses are usually claimed as miscellaneous deductions on Schedule A, Form 1040. Generally, you can deduct only that part of your miscellaneous deductions that is more than 2% of your adjusted gross income. See Chapter 30.

Child and dependent care credit. If you pay someone to care for your dependent who is under 15, your disabled dependent, or your disabled spouse, so that you can work or look for work, you may be able to take a tax credit of up to 30% of the amount you pay. See Chapter 33.

Employment taxes for household employees. If you pay someone, such as a babysitter, to work in your home, you may have to pay employment taxes. See Chapter 33.

Credit for the elderly or the disabled. If you are 65 or older, or retired on permanent and total disability, you may be able to claim a special tax credit. The credit is figured on Schedule R, *Credit for the Elderly or the Disabled,* and claimed on Form 1040. See Chapter 34.

Credit or refund on diesel-fuel vehicles. If you bought a new diesel-powered car, van, or light truck, you may be entitled to a one-time credit or refund of diesel fuel tax. See Chapter 35.

Government employees. If you received wages from the U.S. government, a state, or a local government that were subject only to the 1.45% medicare part of the social security tax, and your total wages from all jobs you had during the year, as well as any self-employment earnings, were more than $45,000, you may be able to claim a credit for excess medicare tax withheld. See Chapter 35.

If you work abroad or have income from foreign countries or U.S. possessions, you may be entitled to certain benefits. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

Filing reminders. Before you file your return, be sure you:

Attach all Forms W-2 to your return.

Attach all forms and schedules in attachment sequence number order. The attachment sequence number is in the upper right corner of the schedule or form. Attach all other statements or attachments last, even if they relate to another form or schedule. Do not attach these other statements to the related form or schedule.

Fill out Schedule SE (Form 1040) if you earned less than $45,000 subject to social security or RRTA withholding and had self-employment income of $400 or more (or Form W-2 wages of $100 or more from an electing church or church-controlled organization).

Put all income, deductions, credits, and tax items on the correct lines.

Use the correct chart or worksheet if you took the standard deduction.

Use the correct column in the Tax Table or the appropriate Tax Rate Schedule.

Check your math carefully.

Sign and date your return. On a joint return both husband and wife must sign.

Attach your check or money order for the full amount you owe. Write your social security number, daytime telephone number, form number, and tax year on your check or money order.

Use the addressed envelope that came with your return (unless you moved during the year) and make sure it has enough postage.

Note: If you pay two federal taxes at the same time, such as the balance due on your 1988 tax liability and the first installment of your 1989 estimated income tax, please use separate checks or money orders. In addition, mail your 1989 estimated tax payments in a separate envelope to the address for your area given in the Form 1040ES instructions.

Rounding off. It is easier to complete your tax return if you "round off" all money amounts. This means that you drop amounts under 50 cents. For example, $25.32 becomes $25.00. You increase to the next dollar amounts that are 50 cents or more, so that, for example, $25.50 becomes $26.00.

If you have to add two or more amounts to figure the total to enter on a line of your return, include cents when adding the amounts and only round off the total.

Example. You receive two W-2 forms: one showing wages of $5,000.55 and one showing wages of $18,500.73. On your form you would enter $23,501 ($5,000.55 + $18,500.73 = $23,501.28) instead of $23,502 ($5,001 + $18,501).

You must be consistent and use "rounding off" throughout your return.

Address label. Transfer the address label from the tax return package you received in the mail to your tax return and make any necessary corrections to it. Use the label from your federal tax return package and not the one that came with your state tax return. Use of the label helps us identify your account, saves processing time, and speeds refunds.

Address change. If you move after you file your return and you are expecting a refund, you should notify the post office serving your old address. Also notify the IRS Service Center where you filed your return of your address change. This will help to forward your check to your new address as soon as possible.

Where to file. Mail your return in the addressed envelope that came with your 1988 income tax form instructions.

If you moved during the year, or if you do not have an addressed envelope, mail your return to the address listed for your area under *Where to File* on the back cover of this publication.

Free tax help. A videotape of tax return instructions is available in either English or Spanish at participating libraries.

Information publications. Over 90 publications with information about taxes are available free of charge from the Internal Revenue Service. See the *Tax Publications* list near the end of this publication.

Taxpayer assistance. The following tell you where to get free tax assistance:

- **Publication 910,** *Guide to Free Tax Services,* describes IRS services available to taxpayers.
- **Tele-Tax.** The Internal Revenue Service has a telephone service called Tele-Tax. This service provides recorded tax information tapes on about 140 topics. See *Tele-Tax,* near the end of this publication, for more information.

Free telephone assistance for taxpayers overseas. Toll-free assistance for U.S. citizens residing in Canada and the European countries of Denmark, France, Germany, Italy, the Netherlands, Sweden, Switzerland, and the United Kingdom is expected to be available sometime after January 1, 1989. The IRS plans to extend this service to other countries at some future date. When this service is available, the toll-free telephone numbers will be widely publicized.

Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). Free help is available in most communities to lower income, elderly, handicapped, and non-English speaking individuals in preparing Form 1040EZ, Form 1040A, and the basic Form 1040. Call the toll-free telephone number for your area for the location of the volunteer assistance site near you.

Information for the blind. Braille materials are available at Regional Libraries for the Blind and Physically Handicapped in conjunction with the Library of Congress. These materials include Publications 17 and 334, Forms 1040, 1040A, and 1040EZ, and Schedules A and B, and instructions.

Telephone service for the deaf is available to deaf taxpayers who have access to TV/telephone—TTY equipment. For more information, call 1-800-428-4732 (Indiana residents call 1-800-382-4059).

Telephone help. The Internal Revenue Service has representatives available to answer your tax questions by telephone. If, after reading the tax form instructions and IRS tax publications, you are unsure about how to fill out your return, or you have a question about an IRS notice, please call the IRS toll-free number for your area. These numbers are listed near the back of this publication.

Walk-in service. While the Internal Revenue Service will not prepare tax returns, assistors are available in most IRS offices throughout the country to help taxpayers prepare their own returns. Taxpayers will be expected to help themselves to the maximum extent possible. However, they will be provided assistance and, at the same time, provided the opportunity of learning how to research and prepare their own tax returns. An assistor will "walk through" a return with a number of taxpayers in a group setting.

A walk-in counter is available in many IRS offices to help with inquiries that do not involve preparation of a return, such as receipt of an IRS notice or bill. Certain technical information or publications may also be obtained at most IRS offices.

Taxpayers who wish assistance with their tax returns should bring in their tax packages, Forms W-2 and 1099, and any other information (such as a copy of last year's return) that will enable the IRS to help.

Written tax questions. Instead of calling or visiting an Internal Revenue office, you may send your written tax questions to the IRS District Director for your area. If you do not have the address, you may get it by calling the IRS toll-free number for your area. These numbers are listed near the back of this publication.

Tax return preparers. Choose your preparer carefully. If you pay someone to prepare your return, the preparer is required, under the law, to sign the return and fill in the other blanks in the Paid Preparer's area of your return. Remember, however, that you are still responsible for the accuracy of every item entered on your return. If there is any underpayment, you are responsible for paying it, plus any interest and penalty that may be due. Therefore, you should be careful to choose someone who understands tax matters and will prepare a complete and accurate tax return.

Refund information. Normally, you will receive your refund about six weeks after filing your return. If it has been at least 8 weeks since you mailed your 1988 tax return, you can call a telephone number to find out the status of your income tax refund. For details on how to use this service, see *Tele-Tax*, near the back of this publication.

Refund more or less than expected. If you are not entitled to a refund, or if your overpayment should have been credited to estimated tax, do not cash the check. Call the IRS toll-free number for your area.

If the amount of the refund is more than you claimed, do not cash the check until you receive a notice explaining the difference.

If the amount of the refund is less than you claimed, it should be accompanied by an explanation. Cashing the check does not stop you from claiming an additional amount of refund.

If you have any questions about the amount of your refund, call the IRS toll-free number for your area.

Corresponding with IRS. Be sure to include your social security number in any correspondence with IRS.

Unresolved tax problems. The Problem Resolution Program is for taxpayers who have been unable to resolve their problems with the Internal Revenue Service. If you have a tax problem you cannot clear up through normal channels, write to your local Internal Revenue Service District Director or call your local Internal Revenue Service office and ask for Problem Resolution assistance.

Although this office cannot change the tax law or technical decisions, it can assist in resolving problems that resulted from previous contacts.

Privacy Act and paperwork reduction information. The Privacy Act of 1974 and the Paperwork Reduction Act of 1980 say that when we ask you for information we must tell you our legal right to ask for the information, what major purpose we have in asking for it and how it will be used, what could happen if we do not receive it, and whether your response is voluntary, required to obtain a benefit, or mandatory under the law. A complete statement on this subject can be found in the instructions for Form 1040, Form 1040A, and Form 1040EZ.

Part I
The Income Tax Return

The five chapters in this part provide basic information on the tax system. They take you through the first steps of filling out a tax return — such as deciding what your filing status is, how many exemptions you can take, and which form to file. They also discuss recordkeeping requirements, and the two methods used to pay tax during the year: withholding and estimated tax.

1. Filing Your Return

Important Change for 1988

Filing requirements. Generally, the amount of income you can have before you are required to file a return has been increased.

This chapter explains the general requirements and process for filing a return. It discusses:

Who Must File,
Who Should File,
Which Form to Use,
How to File,
When to File,
Refunds, Amount You Owe, and Penalties,
Amended Returns and Claims for Refund,
Where to File, and
Recordkeeping.

Who Must File

If you are a citizen or resident of the United States or a resident of Puerto Rico, you must file a federal income tax return if you meet the filing requirements for any of the following categories:

- Individuals—In General
- Dependents
- Self-Employed Persons
- Surviving Spouses, Executors, Administrators, or Legal Representatives
- U.S. Citizens Living Abroad
- Residents of Puerto Rico
- Aliens

These filing requirements apply even if you owe no tax.

Individuals—In General

If you are a U.S. citizen or resident, your filing requirement depends on your gross income, your filing status, and your age. For 1988, whether you are blind is not a factor.

Gross income includes all income you receive in the form of money, goods, property, and services that is not exempt from tax. If you are married and live with your spouse in a community property state, half of any income described by state law as community income may be considered to be yours. See Publication 555, *Community Property and the Federal Income Tax.* Common types of income are discussed in the chapters in Part II of this publication.

Filing status is determined as of the last day of your tax year, which is December 31 for most taxpayers. See Chapter 2 for an explanation of each filing status.

Age. You are considered 65 on the day before your 65th birthday.

If you are single, you must file a return if you had gross income of $4,950 or more for the year. The requirement is $5,700 if you are 65 or older. The requirements for dependents are different. See *Dependents,* later.

If you are married, you must file a tax return if your combined gross income was $8,900 or more, provided you are eligible to file a joint return, are living together at the close of the tax year and both of you are under 65. The requirement is $9,500 if one spouse is 65 or older, and $10,100 if both of you are 65 or older. The requirements for dependents are different. See *Dependents,* later.

If you are married and your spouse files a separate return, or you did not share the same household at the end of the year, you must file a tax return if your gross income was $1,950 or more.

If you are a qualifying head of household, you must file a tax return if you had gross income of $6,350 or more for the year. The requirement is $7,100 if you are 65 or older. See *Head of Household* in Chapter 2.

If you are a qualifying widow or widower, you must file a tax return if you had gross income of $6,950 or more for the year. The requirement is $7,550 if you are 65 or older. See *Qualifying Widows and Widowers* in Chapter 2.

Generally, if you are a U.S. citizen or resident, you must file a tax return if your gross income for the year is at least as much as the amount shown for your filing status and age in the table below. Dependents should see *Dependents,* later.

Filing Status*	1988 Gross Income
Single	
Under 65	$ 4,950
65 or older	5,700
Married Filing Joint Return	
Both spouses under 65	$ 8,900
One spouse 65 or older	9,500
Both spouses 65 or older	10,100
Not living with spouse at end of year (or on date spouse died)	1,950
Married Filing Separate Return	
All—regardless of age	$ 1,950
Head of Household	
Under 65	$ 6,350
65 or older	7,100
Qualifying Widow(er)	
Under 65	$ 6,950
65 or older	7,550

*Being blind does not change your filing requirement.

Even if your income is less than the amount shown as your filing requirement, you must file a return if you owe any taxes, such as:

- Self-employment tax on net earnings from self-employment of at least $400.
- Social security tax on tips you did not report to your employer. See Chapter 7.
- Uncollected social security tax or railroad retirement tax on tips you reported to your employer. See Chapter 7.
- Alternative minimum tax. See Chapter 31.
- Tax on an individual retirement arrangement (IRA), or on a qualified retirement plan. See Chapter 20.
- Tax you may have to repay on an investment credit or low-income housing credit you claimed in a previous year. See Publication 572, *General Business Credit.*

If you receive any advance earned income credit payments from your employer, you must file a return. See Chapters 5 and 35.

Wages exempt from employer social security taxes. Even if you are not otherwise required to file, you must file a return if you had wages of $100 or more from a church or qualified church-controlled organization that is exempt from employer social security taxes. See Publication 533, *Self-Employment Tax.*

Income from U.S. Possessions. If you had income from Guam, the Northern Mariana Islands, American Samoa, the Virgin Islands, or Puerto Rico, special rules may apply in determining whether you must file a return. You may also have to file a return with the individual Island Government. See Publication 570, *Tax Guide for Individuals in U.S. Possessions* for more information.

Dependents

Whether a dependent has to file a return generally depends on the amount of earned and unearned income the dependent has, whether the dependent is single or married, the dependent's age, and whether he or she is blind.

Earned Income Only

If all of a dependent's income is earned income, the dependent must file a return if his or her gross (total) income is more than the amount listed in the following table:

Filing Status	Amount
Single	
Under 65	$3,000
Either 65 or older or blind	$3,750
65 or older and blind	$4,500
*Married Filing Separate Return**	
Under 65	$2,500
Either 65 or older or blind	$3,100
65 or older and blind	$3,700

* If dependent's spouse itemizes deductions on a separate return, dependent must file if dependent had at least $5 of gross income (earned or unearned).

Unearned Income Only

If all of a dependent's income is unearned income, the dependent must file a return if his or her gross (total) income is more than the amount shown in the following table:

Filing Status	Amount
Single	
Under 65	$ 500
Either 65 or older or blind	$1,250
65 or older and blind	$2,000
*Married Filing Separate Return**	
Under 65	$ 500
Either 65 or older or blind	$1,100
65 or older and blind	$1,700

* If dependent's spouse itemizes deductions on a separate return, dependent must file if dependent had at least $5 of gross income (earned or unearned).

Earned and Unearned Income

If a dependent has both earned and unearned income, the dependent generally must file a return if his or her gross (total) income is more than $500.

If the dependent is 65 or older or blind, he or she must file a return if his or her gross (total) income is more than the amount from line 7 of the following worksheet.

Filing Requirements Worksheet for Dependents Who Are 65 or Older or Blind

1. Enter dependent's earned income (defined later) .... ______
2. Minimum amount .... $ 500
3. Compare the amounts on lines 1 and 2. Enter the ***larger*** of the two amounts .... ______
4. Enter the appropriate amount from the following table. .... ______

Filing Status	Amount
Single	$3,000
Married Filing Separately	$2,500

5. Compare the amounts on lines 3 and 4. Enter the ***smaller*** of the two amounts ..... ______
6. Enter the amount from the following table that applies to the dependent .... ______

Filing Status	Amount
Single	
Either 65 or older or blind	$ 750
65 or older and blind	$1,500
Married Filing Separately	
Either 65 or older or blind	$ 600
65 or older and blind	$1,200

7. Add the amounts on lines 5 and 6. Enter the total .... ______
8. Enter the dependent's total income .... ______

If the amount on line 8 is more than the amount on line 7, the dependent ***must*** file an income tax return.

Earned income is salaries, wages, tips, professional fees, and other amounts received as pay for work actually done.

Unearned income is income other than earned income (salaries or wages). It is investment-type income and includes interest, dividends, and capital gains. Distributions of interest, dividends, capital gains, and other unearned income from a trust are also unearned income to a beneficiary of the trust.

Liability of parent. If a dependent child with taxable income cannot file an income tax return, a parent, guardian, or other legally responsible person must file it for the child. If the child cannot sign the return, the filer must sign the child's name followed by the words "By (your signature), parent (or guardian) for minor child."

If a child's tax is not paid, the parent or guardian is liable for the income tax on salaries and wages of the child.

Child's income. A child's earnings are taxable to him or her even if under local law the child's parents have the right to the earnings and may actually have received them.

A child's income is ***not*** included on his or her parents' return.

Self-Employed Persons

If you are self-employed, you must file a return if you had net earnings from self-employment of $400 or more. Net earnings from self-employment generally are the net income (gross income minus deductible business expenses) from your business or profession. For more information, see Publication 533, *Self-Employment Tax.*

The $400 net earnings figure applies to self-employed persons of any age.

You must include your net self-employment income in your gross income even if your net self-employment income is less than $400.

You are self-employed if you carry on a trade or business as a sole proprietor, are an independent contractor or an active member of a partnership, or are otherwise in business for yourself.

Self-employment includes more than regular full-time business activities. It also includes certain part-time work that you do at home or in addition to your regular job.

You must pay self-employment tax on your net earnings from self-employment. This tax is comparable to the social security tax withheld from an employee's wages. An individual who earned less than $45,000 in 1988 as an employee and earned $400 or more from self-employment normally has to pay self-employment tax. The self-employment tax rate for 1988 is 13.02%. Use Schedule SE (Form 1040), *Social Security Self-Employment Tax,* to figure your tax. Attach it to Form 1040. A copy of this schedule is shown in Chapter 38.

A U.S. citizen who works in the United States for an international organization, a foreign government, or a wholly owned instrumentality of a foreign government, and who is exempt from social security employee tax, has to pay self-employment tax on earnings from services performed in the United States.

Surviving Spouses, Executors, Administrators, or Legal Representatives

You must file a final return for a decedent (a person who died) if:

- You are the surviving spouse, executor, administrator, or legal representative, and
- The decedent met the filing requirements for individuals in general or for self-employed persons at the date of death.

For more information, see Chapter 4.

U.S. Citizens Living Abroad

If you are a U.S. citizen living outside the United States, you must file a return if you meet the filing requirements for individuals in general or for self-employed persons. For more information, see Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad,* available at most U.S. Embassies and consulates, or you may use the order blank at the end of this publication.

Residents of Puerto Rico

If you are a resident of Puerto Rico, you must file a U.S. income tax return if you meet the income requirements for individuals in general or for self-employed persons. However, if you are a resident of Puerto Rico for the whole year, your U.S. gross income does not include income from sources within Puerto Rico, except income received for your services as an employee of the United States or any U.S. agency. For more information, see Publication 570, *Tax Guide for Individuals in U.S. Possessions.*

Aliens

Your status as an alien—resident, nonresident, or dual-status—determines how you file your income tax return.

Determining your status. The rules to determine if you are a resident or nonresident alien are discussed in Publication 519, *U.S. Tax Guide for Aliens.*

Resident aliens. If you are a resident alien for the entire year, you must file a tax return following the same rules that apply to U.S. citizens. Use the forms discussed in this publication.

Nonresident aliens. If you are a nonresident alien for the entire year (unless you live in Puerto Rico for the entire year), the rules and tax forms that apply to you may be different from those that apply to U.S. citizens. See Publication 519 to find out if U.S. income tax laws apply to you and which forms you should file.

Certain nonresident aliens married to U.S. citizens or residents may choose to file a joint return and use the forms discussed in this publication. See Publication 519 for details.

Dual-status taxpayers. If you were both a resident alien and a nonresident alien in the same tax year, you are a dual-status taxpayer and have a dual-status tax year. Different rules apply for the part of the year you were a resident of the United States and the part of the year you were a nonresident. For information on dual-status taxpayers, get Publication 519.

If you were married to a person who was a U.S. citizen or resident on the last day of the tax year, you may be able to file a joint return with your spouse. See Publication 519.

Who Should File

Even if you are not required to file, you should file a federal income tax return if:

- You had income tax withheld from your pay. By filing a return, you can get a refund even if you can be claimed as a dependent by another taxpayer.
- You qualify for the earned income credit. See *Earned Income Credit* in Chapter 35 for more information.

Which Form to Use

There are three forms you can choose from to file your return—Form 1040EZ, Form 1040A, and Form 1040.

Filing Requirement Charts

The three charts that follow can be used to determine whether a dependent needs to file a return.

Chart 1 is for all dependents who are under 65 and not blind.
Chart 2 is for unmarried dependents who are 65 or older or blind.
Chart 3 is for married dependents who are 65 or older or blind.

Use only the chart that fits the dependent's circumstances.

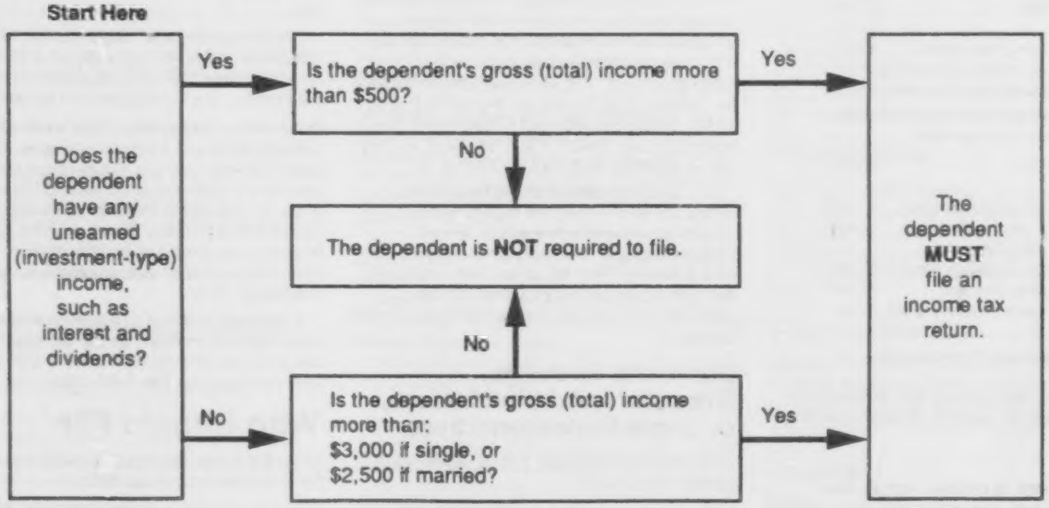
Do not use a chart for the following dependents:

A married dependent who has at least $5 of income and whose spouse itemizes deductions on a separate return,
A dependent with at least $400 of net self-employment income,
A dependent who owes certain other taxes, or
A dependent who had income tax withheld.

These dependents either must file, or should file to receive a refund.

How to use the charts. Answer the questions in the block labeled "Start Here." Follow either the arrow marked "Yes" or the arrow marked "No" (depending on your answer to the question in the block). Continue answering questions and following arrows until you reach a block that does not have a question in it. That block will tell you whether or not the dependent needs to file a return.

Chart 1. Dependents Under 65 and Not Blind



Does the dependent have any unearned (investment-type) income, such as interest and dividends?

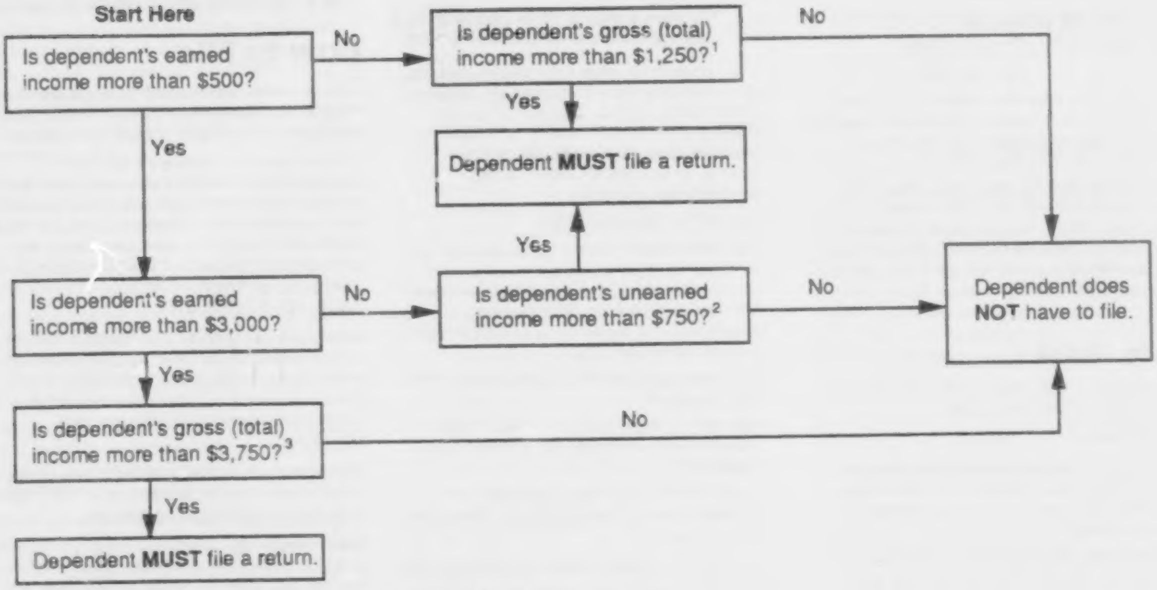
Is the dependent's gross (total) income more than $500?

The dependent is **NOT** required to file.

Is the dependent's gross (total) income more than:
$3,000 if single, or
$2,500 if married?

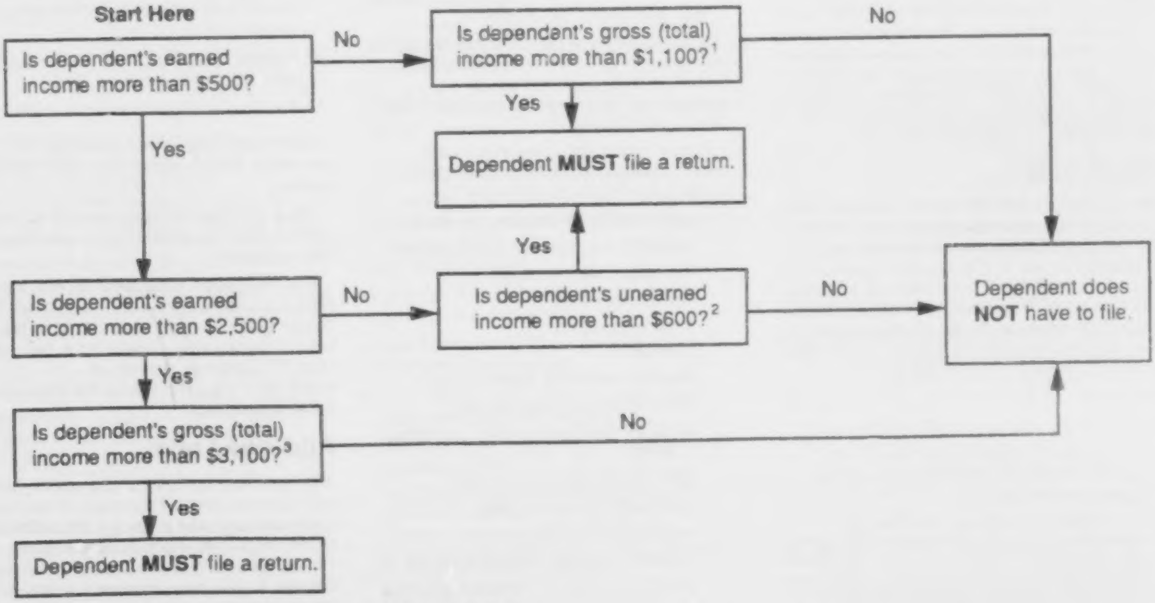
The dependent **MUST** file an income tax return.

Chart 2. Single Dependents 65 or Older or Blind


Start Here
Is dependent's earned income more than $500?
No
Is dependent's gross (total) income more than $1,250?[1]
No
Yes
Dependent MUST file a return.
Yes
Yes
Is dependent's earned income more than $3,000?
No
Is dependent's unearned income more than $750?[2]
No
Dependent does NOT have to file.
Yes
Is dependent's gross (total) income more than $3,750?[3]
No
Yes
Dependent MUST file a return.

[1] Use $2,000 if the dependent is 65 or older *and* blind.
[2] Use $1,500 if the dependent is 65 or older *and* blind.
[3] Use $4,500 if the dependent is 65 or older *and* blind.

Chart 3. Married Dependents 65 or Older or Blind


Start Here
Is dependent's earned income more than $500?
No
Is dependent's gross (total) income more than $1,100?[1]
No
Yes
Dependent MUST file a return.
Yes
Yes
Is dependent's earned income more than $2,500?
No
Is dependent's unearned income more than $600?[2]
No
Dependent does NOT have to file.
Yes
Is dependent's gross (total) income more than $3,100?[3]
No
Yes
Dependent MUST file a return.

[1] Use $1,700 if the dependent is 65 or older *and* blind.
[2] Use $1,200 if the dependent is 65 or older *and* blind.
[3] Use $3,700 if the dependent is 65 or older *and* blind.

Form 1040EZ

If you are single, you may be able to use the simpler Form 1040EZ.

You may use Form 1040EZ if:

- Your filing status is single,
- You were not 65 or older or blind,
- You do not claim any dependents,
- Your taxable income is less than $50,000 and is only from wages, salaries, tips, taxable scholarships and fellowships, and from interest of $400 or less, and
- You do not itemize deductions, claim any adjustments to income or tax credits, or owe any taxes other than the amount from the Tax Table. If you do not meet all the above requirements, you cannot use Form 1040EZ. You must use Form 1040A or Form 1040.

Form 1040A

If you do not qualify to use Form 1040EZ, you may be able to use Form 1040A.

You may use Form 1040A if:

- Your income is only from wages, salaries, tips, taxable scholarships and fellowships, interest, dividends, and unemployment compensation,
- Your taxable income is less than $50,000,
- You do not itemize your deductions, and
- Your only deduction is for certain contributions to an Individual Retirement Arrangement (IRA). See Chapter 20.
- Your only credits are:
  - a) The credit for child and dependent care expenses. See Chapter 33, and
  - b) The earned income credit. See Chapter 35.

You may not be able to use Form 1040A because of the amount or kind of income you receive, or because you file forms or schedules or pay other taxes that can be reported only on Form 1040. Or, you may want to claim itemized deductions, adjustments to income, or credits that you cannot take on Form 1040A. Check the list under *You must use Form 1040.*

Form 1040

You may have received Form 1040A and Form 1040EZ in the mail because of the return you filed last year. But your situation may have changed this year and it may be to your advantage to file Form 1040 instead. You may pay less tax by filing Form 1040 because you can take itemized deductions, adjustments to income, and some credits that you cannot take on Form 1040A or Form 1040EZ.

You must use Form 1040 if:

- Your taxable income is $50,000 or more.
- You received taxable social security or equivalent railroad retirement benefits, as discussed in Chapter 12.
- You received interest or dividends as a nominee (that is, in your name) for someone else.
- You received or paid accrued interest on securities transferred between interest payment dates.
- You received nontaxable dividends.
- You received capital gain distributions.
- You are required to complete Part III of Schedule B (Form 1040) because:

  At any time during the year you had an interest in or signature or other authority over a bank, securities, or other financial account in a foreign country, or

  You were a grantor of, or transferor to, a foreign trust that existed during 1988.
- You had income other than wages, salaries, tips, unemployment compensation, interest, or dividends, such as pension or annuity income, gain from the sale of your home or other property, barter income, alimony income, or self-employment income (including farm income).
- You itemize your deductions.
- You claim adjustments to gross income for reimbursed employee business expenses, payments to a Keogh plan, penalty on early withdrawal of savings, alimony paid, or certain required repayments of supplemental unemployment benefits.
- You made estimated tax payments for 1988. See Chapter 5.
- You want to apply any part of your 1988 refund to your estimated tax for 1989. See Chapter 5.
- You file Form 2210, *Underpayment of Estimated Tax by Individuals and Fiduciaries.* See Chapter 5.
- You file Form 2555, *Foreign Earned Income.*
- You are a government employee or railroad employee representative and you file Form 4469, *Computation of Excess Medicare Tax Credit.* See Chapter 35.
- You file Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa.*
- Your Form W-2 shows uncollected employee tax (social security tax) on tips. See Chapter 7.
- You received $20 or more in tips in any one month and you did not report all of these tips to your employer. See Chapter 7.
- You must pay tax on an individual retirement arrangement (IRA) and file Form 5329, *Return for Individual Retirement Arrangement and Qualified Retirement Plans Taxes.* See Chapter 20.
- You must pay tax on self-employment income. See Schedule SE (Form 1040), *Social Security Self-Employment Tax.*
- You claim credits against your tax for the:

  credit for the elderly or the disabled,
  mortgage interest credit,
  foreign tax credit,
  investment credit,
  jobs credit,
  credit for prior year minimum tax,
  credit for alcohol used as fuel,
  credit for fuel from a nonconventional source,
  credit for Federal tax on fuels,
  low-income housing credit,
  regulated investment company credit,
  credit for overpaid windfall profit tax, or
  credit for increasing research activities.
- You file Form 8271, *Investor Reporting of Tax Shelter Registration Number.*
- You file Form 4970, *Tax on Accumulation Distribution of Trusts.*
- You file Form 4972, *Tax on Lump-Sum Distributions.* See Chapter 11.
- You have to repay an investment credit you claimed in a previous year.
- You have to pay any section 72 penalty taxes, any alternative minimum tax, or any tax on an excess golden parachute payment.

How to File

In most cases, the Internal Revenue Service will mail you either Form 1040 or Form 1040A and Form 1040EZ with related instructions.

If you have not received a tax return package in the mail, or if you need other forms, you may order them and most publications you need from the Internal Revenue Service Forms Distribution Center for your state using the order blank at the end of this publication or by calling the toll-free number, 1-800-424-FORM(3676).

Substitute tax forms. You may not use your own version of a tax form unless it meets the requirements explained in Publication 1167, *Substitute Printed, Computer-Prepared and Computer-Generated Tax Forms and Schedules.*

Tax help on videotape. A videotape of tax return instructions is available in either English or Spanish at participating libraries.

Electronic filing. Electronic filing is a method by which authorized professional tax preparers transmit tax return information directly to an IRS Center over telephone lines. It is available in 36 states for the 1989 tax season.

The advantages of electronic filing to you are that it:

1) Reduces IRS processing time by up to 3 weeks, resulting in faster refunds,
2) Decreases the likelihood of error conditions being found on your return,
3) Enables you to have your refund deposited directly into your savings or checking account,
4) Results in notification to your preparer that your return was received, and
5) Reduces your government's costs.

Electronic filing neither increases nor decreases the possibility your return will be audited.

For a recorded message about this program, call the Tele-Tax number given near the end of this publication.

For information about whether electronic filing is available in your area, and, if so, the names of tax preparers authorized to file returns electronically in your area, call your local IRS Taxpayer Service, or 1-800-424-1040, and ask for the Electronic Filing Coordinator.

Address Label

After you have completed your return, peel your address label off the cover of your tax return package and place it in the address area of the Form 1040, Form 1040A, or Form 1040EZ you send to the Internal Revenue Service. If you have someone prepare your return, give that person your label to use.

The coding on the label is used by the Internal Revenue Service in processing your return. The label helps to correctly identify accounts. It also saves processing costs and speeds up processing so that refunds can be issued sooner.

Correcting the label. Make necessary name and address changes on the label. If you have an apartment number that is not shown on the label, please write it in. If you and your spouse file a joint return and maintain separate homes, choose one address to enter on your return. If the label is for a joint return and the social security numbers are not listed in the same order as the first names, show the numbers in the correct order. If your social security number is not correct, or if you changed your name, see the discussion later under *Social Security Number.*

If you did not receive a tax return package with a label, print or type your name, address, and social security number in the spaces provided on Form 1040 or Form 1040A. If you file Form 1040EZ without a label, print (do not type) this information in the spaces provided.

P.O. Box. If your post office does not deliver mail to your street address and you have a P.O. box, write your P.O. box number on the line for your present home address instead of your street address.

Different last names. If you and your spouse file a joint return and use different last names, separate the names with ***and.*** For example, John Brown and Mary Smith.

If you are a member of the armed forces, you should include on your return your name, social security number, permanent home address, and ZIP code.

Social Security Number

You must show your social security number on your return. If the number shown on the address label on the tax return package you received in the mail is wrong, mark through it, correct it on the label, and enter the correct number in the space provided on the return. If you did not receive a return with a label, write your number in the space provided.

If you are married, give the social security numbers for both yourself and your spouse, whether you file jointly or separately. If you are filing a joint return, list your social security numbers in the same order that you show your first names.

Changed name. If you changed your name for reasons such as marriage or divorce, you should notify your Social Security Administration office so that the name on your tax return is the same as the one the Social Security Administration has on its records. This may prevent delays in issuing your refund.

Dependent's social security number. If you claim an exemption for a dependent who is at least 5 years old by December 31, 1988, you must list the dependent's social security number on Form 1040 or Form 1040A. The social security number requirement applies to ***all dependents*** claimed on the tax return who are at least 5 years old. After 1989, this requirement will apply to dependents who are at least 2 years old before the end of each tax year.

If you or your dependent who is at least 5 years old do not have a social security number, file a Form SS–5 with your local Social Security Administration office. If you are a U.S. citizen, you must show proof of age, identity, and citizenship with your Form SS–5. If you are 18 or older, you must appear in person. If you have any questions about which documents you can use as proof of age, identity, or citizenship, contact your Social Security Administration office. Form SS–5 is available at any Social Security Administration office. If you or your dependent do not receive a number by the time you are ready to file, you should file your return anyway and write *"Applied for"* in the space provided for the number.

You may have to pay a penalty if you do not give your social security number to another person when you are required to. See *Penalties,* later.

If you contact the Internal Revenue Service about your tax account, be sure to include your social security number in your correspondence. By providing your social security number, we can correctly identify your account and expedite the processing of your correspondence.

Presidential Election Campaign Fund

This fund was set up to help pay for presidential election campaigns.

You may have $1 go to this fund by checking the *Yes* box on Form 1040, Form 1040A, or Form 1040EZ. If you are filing a joint return, your spouse may also have $1 go to the fund.

If you check *Yes,* it will not change the amount of tax you pay or the amount of refund you will receive.

Rounding Off Dollars

All money items on your return may be rounded off to whole dollars, provided you do so for all entries on your return and schedules. This means that you drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, $1.39 becomes $1 and $2.50 becomes $3.

If you have to add two or more amounts to figure the amount to enter on a line, include cents when adding the amounts and only round off the total.

Example. You receive two W–2 forms; one showing wages of $5,000.55 and one showing wages of $18,500.73. On Form 1040, Line 7, you would enter $23,501 ($5,000.55 + $18,500.73 = $23,501.28) instead of $23,502 ($5,001 + $18,501).

Additional Schedules

Depending on the form you file and the items reported on your return, you may have to complete additional schedules and attach them to your return.

If you file Form 1040EZ, no additional schedules are necessary.

If you file Form 1040A, you must attach Schedule 1 and complete:

- Part I to take the ***credit for child and dependent care expenses,***
- Part II to report your ***interest income*** if it is more than $400,
- Part III to report your ***dividend income*** if it is more than $400.

If you file Form 1040, attach the necessary schedules or forms, such as:

- Schedule A to show your ***itemized deductions,***
- Schedule B to report ***interest and dividends*** (including capital gain and nontaxable distributions) if either is more than $400, or to answer the ***foreign accounts and foreign trusts*** questions,
- Schedule C to report profit or loss from your ***business or profession,***
- Schedule D to report ***capital gains and losses, and to reconcile Forms 1099–B to your return,***
- Schedule E to report income or loss from ***rents, royalties, partnerships, estates, trusts, S corporations, and REMICs (residual interests),***
- Schedule F to report ***farm income and expenses,***
- Schedule R if you claim the ***credit for the elderly or the disabled,***
- Schedule SE to figure ***self-employment tax.***

Assembling your return. Attach all forms and schedules in order of the "Attachment Sequence Number" that is shown in the upper right corner of the form or schedule. Attach all other statements or attachments last, even if they relate to another form or schedule. Do not attach these other statements to the related form or schedule.

If you owe tax, be sure to attach your payment to the front of your Form 1040, Form 1040A, or Form 1040EZ.

Foreign financial accounts and foreign trusts. You must complete Part III of Schedule B (Form 1040) if you received more than $400 in interest or more than $400 in dividends, or if you had a foreign account or were the grantor of, or transferor to, a foreign trust.

If you checked *Yes* for the question on line 10, Part III of Schedule B, file Form TD F 90–22.1, *Report of foreign bank and financial accounts* by June 30, 1989, with the Department of the Treasury at the address shown on the form. Form TD F 90–22.1 is not a tax return, so do not attach it to your Form 1040. Be sure to file your Form 1040 with the Internal Revenue Service. You can get Form TD F 90–22.1 by using the order blank at the end of this publication.

For more information, see the instructions for Part III of Schedule B (Form 1040).

Form W–2. Form W–2, *Wage and Tax Statement,* is a statement from your employer of the wages and other compensation paid to you and the taxes withheld from your pay. If you worked for more than one employer during the year, you should have a Form W–2 from each employer. Be sure to attach the first copy or copy B of Form W–2 to the front of your return. For more information, see *Form W–2* in Chapter 5.

Signatures

You must sign and date your return. If you file a joint return, both you and your spouse must sign the return, even if only one of you had income.

If you prepare your own return, leave the space under your signature blank.

If someone prepares your return and does not charge you, that person should not sign your return.

Generally, anyone who is paid to prepare, assist in preparing, or review your tax return must sign it and fill in the other blanks in the paid preparer's area of your return. Paid preparers of Form 1040EZ must sign the return and provide all other required information at the bottom of the form below the area for the taxpayer's signature.

If the preparer is self-employed (that is, is not employed by any person or business to prepare the return), he or she should check the self-employed box on Form 1040 or Form 1040A.

The person required to sign your return must fill in the required preparer information and sign it in the space provided for the preparer's signature. Signature stamps and labels are not acceptable. The preparer must also give you a copy of your return in addition to the copy filed with the Internal Revenue Service.

If you have questions about whether a preparer must sign your return, please contact any Internal Revenue Service office.

Occupations. If you file Form 1040 or Form 1040A, enter your occupation in the space provided in the signature section. If you file a joint return, enter both your occupation and your spouse's occupation.

Accounting Periods and Methods

You must figure your taxable income for a fixed period of time. This is an accounting period. You must account for your income and deductions in a way that clearly shows your taxable income. This is an accounting method.

Accounting Periods

Most individual tax returns cover a ***calendar year***—the 12 months from January 1 through December 31. This is one accounting period. Another is the ***fiscal year***—a 12-month period that ends on the last day of any month except December.

You must choose your accounting period when you file your first income tax return. It may never be longer than 12 months. To change your accounting period, you must get permission from the Internal Revenue Service. If you want to change your accounting period, get Form 1128, *Application for Change in Accounting Period.*

Example. During 1987 you were an employee and earned $15,000. You filed your 1987 income tax return on the calendar year basis. On July 1, 1988, you quit your job and opened your own repair shop. For business reasons, you want to file your income tax return on a fiscal year basis from July 1, 1988, to June 30, 1989. To change your accounting period, complete and submit Form 1128. The new period may not be used until you receive approval.

For more information on accounting periods, see Publication 538, *Accounting Periods and Methods.*

Accounting Methods

An accounting method is the way you account for your income and deductions. The two accounting methods used most often are the cash method and the accrual method.

The cash method. If you use this method, report all items of income in the year in which you actually or constructively receive them. Deduct all expenses in the year you pay them. This is the method most individual taxpayers use.

Income is constructively received when it is credited to your account, or is set apart in any way that makes it available to you. You do not need to have physical possession of it. For example, the amount of dividends or interest credited to your account by a bank or savings and loan association on December 31, 1988, is taxable income to you in 1988 if you could withdraw it in 1988, even if the amount is not entered in your passbook or withdrawn until 1989.

Garnisheed wages. If your employer uses your wages to pay your debts, or if your wages are attached or garnisheed, the full amount is constructively received by you. You must include it in your income for the year in which you would otherwise have actually received it.

Brokerage and other accounts. Even though you do not withdraw profits from your brokerage or other account, they are fully taxable in the year you earn them. This is true even if the credit balance in your accounts is reduced or eliminated by losses in later years, or if your current profits are used to reduce or eliminate a debit balance from previous years.

If another person cancels or pays your debts (but not as a gift or loan to you), you have constructively received the amount and must include it in your gross income for the year.

If a third party is paid income from property you own, you have constructively received the income. It is the same as if you had actually received the income and paid it to the third party.

Income received by an agent for you is income constructively received by you in the year the agent receives it. If you indicate in a contract that your income is to be paid to another person, you must include the amount in your gross income when the other person receives it.

A valid check received by you or available to you before the end of the tax year is constructively received by you in that year, even if you do not cash the check or deposit it in your account until the next year.

There may be facts to show that you did not constructively receive income.

Example. Alice Johnson, a teacher, agreed to a school board's condition that, in her absence, she would receive only the difference between her regular salary and the salary of a substitute teacher hired by the school board. Therefore, Alice did not constructively receive the amount by which her salary was reduced to pay the substitute teacher.

The accrual method. If you use this method, you report income when you earn it, whether or not you receive it. You deduct your expenses when you incur them, rather than when you pay them.

Prepaid income generally is included in gross income in the year you receive it. Your method of accounting does not matter as long as the income is available to you. Prepaid income includes rents or interest received in advance and compensation for services to be performed later.

Advance payments for services. If, under an agreement, you receive payment for services to be performed by the end of the next tax year, you may defer these payments from income until you earn them by doing the service. You ***must*** be an accrual method taxpayer to defer advance payments. You cannot defer them beyond the year after the year you receive them. For more information, see Publication 538, *Accounting Periods and Methods.*

Changing your accounting method. Once you have chosen your accounting method, you ordinarily may not change it without the permission of the Internal Revenue Service. However, you may use a different method for each business you have.

Example. You work for a salary and use the cash method to report that income on your tax return. You open a gift shop, and continue to work for a salary. Even though you use the cash method for your salary, you may use the accrual method for reporting income from your gift shop.

If you want to change your accounting method, get Form 3115, *Application for Change in Accounting Method.* For more information on accounting methods, see Publication 538.

When to File

April 17, 1989, is the final date for filing your 1988 income tax return if you use a calendar year. If you use a fiscal year (a year ending on the last day of any month except December, or a 52/53 week year), your income tax return is due by the 15th day of the 4th month after the close of your fiscal year.

When the due date for doing ***any*** act for tax purposes—filing a return, paying taxes, etc.—falls on a Saturday, Sunday, or legal holiday, you may do that act on the next business day.

Your return is filed on time if it is properly addressed and postmarked no later than the due date. The return must have sufficient postage. If you send a return by registered mail, the date of the registration is the postmark date. The registration is evidence that the return was delivered. If you send a return by certified mail and have your receipt postmarked by a postal employee, the date on the receipt is the postmark date. The postmarked certified mail receipt is evidence that the return was delivered.

If you do not file your return by the due date, you may have to pay a failure-to-file penalty and interest. See *Penalties,* later.

If you are a nonresident alien and earn wages that are subject to U.S. income tax withholding, your 1988 U.S. income tax return is due April 17, 1989, if you file on a calendar year basis, or the 15th day of the 4th month after the end of your fiscal year. If your earnings are not subject to withholding, your return is due June 15, 1989, if you file on a calendar year basis, or the 15th day of the 6th month after the close of your fiscal year.

If you must file a final return as an executor, administrator, legal representative, or surviving spouse of a taxpayer who died during the year, the income tax return is due on the 15th day of the 4th month after the close of the deceased taxpayer's normal tax year. See Chapter 4. In most cases, for a 1988 return this will be April 17, 1989.

Extensions of Time to File

You may not use Form 1040EZ or have the Internal Revenue Service figure your tax if you ask for an extension of time to file your return.

Automatic extension of time to file. You may get an automatic 4-month extension of time to file your 1988 Form 1040A or Form 1040. To get the automatic extension, you must file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return.*

When to file. You must file Form 4868 by April 17, 1989, with the Internal Revenue Service Center for your area. If you are filing a fiscal year return, file Form 4868 by the regular due date for your return. You may file Form 1040A or Form 1040 any time before the 4-month extension period ends.

Note. Any extension of time granted for filing your 1988 calendar year income tax return also extends the time for filing a 1988 gift tax return.

An extension of time to file is not an extension of time to pay. You must make an estimate of your tax for the year and pay any tax due with Form 4868. There is a penalty for paying the tax late unless you have reasonable cause for not paying your tax when due.

When you file your return, enter any payment you made with Form 4868 on line 57, Form 1040. If you file Form 1040A, include the amount paid with Form 4868 in the total on line 24, Form 1040A. Also write "Form 4868" and the amount in the space to the left of line 24.

If you underestimated the amount you owe, you have to pay interest on the unpaid amount. If the unpaid amount is more than 10% of your tax, you will have to pay, in addition to interest, a failure-to-pay penalty discussed later. Any interest or penalty applies from the original due date of the return, which is usually April 15.

Extensions beyond the automatic 4–month extension of time to file are granted only for very good reasons. An extension of more than 6 months will not be granted if you are in the United States. However, if you are outside the United States, you may be granted a longer extension.

You apply for an extension beyond the 4–month extension either in a letter or by filing Form 2688, *Application for Additional Extension of Time To File U.S. Individual Income Tax Return.* You should request the extension early so that, if refused, you will still be able to file on time. Except in undue hardship cases, Form 2688 or a request by letter will not be accepted until you have first used Form 4868 to get an automatic 4–month extension. Form 2688 or your letter will not be considered if you file it after the extended due date.

To get an extension beyond the automatic 4–month extension, you must give the following information:

- The reason for requesting the extension,
- The tax year to which the extension applies,
- The length of time needed for the extension, and
- Whether another extension of time to file has already been granted for this tax year.

You may sign the request for this extension or it may be signed by your attorney, CPA, enrolled agent, or a person with a power of attorney. If you are unable to sign the request because of illness or for another good reason, a person in close personal or business relationship to you may sign for you, stating why you could not sign the request.

If your application for this extension is approved, you will be notified by the Internal Revenue Service. Attach the notice to your return when you file it.

If an extension is granted and the Internal Revenue Service later determines that the statements made on your request for this extension are false and misleading and an extension would not have been granted at the time based on the true facts, the extension is null and void. You will have to pay the failure-to-file penalty (discussed later) from the original due date of the return.

If your application for this extension is not approved, you must file your return by the extended due date of the automatic extension. You may be allowed to file within 10 days of the date of the notice you get from the Internal Revenue Service if the end of the 10–day period is later than the due date. The notice will tell you if the 10–day grace period is granted.

Extensions—Special Rule

If you are a U.S. citizen or resident whose home and main place of business or post of duty are outside the United States and Puerto Rico on April 17, 1989, you are allowed an automatic extension until June 15, 1989, to file your return and pay any tax due for 1988. If you file your return on a fiscal year basis, you are allowed a 2–month extension beyond the regular due date of your return.

If you file a joint return, only one spouse need qualify for this automatic extension to apply. However, if you and your spouse file separate returns, this automatic extension applies only to the spouse who qualifies.

Military personnel on duty outside the United States and Puerto Rico on April 17, 1989, also are allowed an automatic 2–month extension of time for filing.

If you use this automatic extension, you must attach a statement to your return saying that your home and your main place of business are outside the United States and Puerto Rico on the due date of your return. You must pay interest on any unpaid tax from the due date to the date you pay the tax.

If you need additional time, you can get an additional automatic 2–month extension of time to file your return. You must file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return,* by June 15, 1989, to get the extension. This additional 2–month extension of time to file is ***not*** an extension of time to pay any tax you may owe. You must make an estimate of your tax for the year and pay any tax due with Form 4868.

U.S. citizens living abroad should get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad,* for more information.

Refunds

If you overpay your income taxes, you can get a refund of the amount you overpaid. Or, you may choose on your Form 1040 to apply all or part of the overpayment to your next year's estimated tax.

If you use Form 1040 and you overpaid your tax, show on lines 63 and 64 the amount you want refunded and the amount you want to apply to your estimated tax. If you use Form 1040A and you overpaid your tax, show your refund on line 25. If you use Form 1040EZ and you overpaid your tax, show your refund on line 10. You may not have your overpayment apply to your estimated tax if you file Form 1040A or Form 1040EZ.

A refund of less than one dollar will not be made unless you attach a separate statement to your return requesting it.

Interest

If you are due a refund, no interest will be paid if the refund is made within 45 days of the due date of the return. If you file your return after the due date (including extensions), no interest will be paid if the refund is made within 45 days of the date you filed. If the refund is not made within this 45–day period, interest will be paid from the due date of the return or from the date you filed, whichever is later.

For purposes of determining whether any interest is due on a refund, your return will not be treated as filed until it is filed on a permitted form, contains information that identifies you, is signed by you, and contains sufficient information for mathematical verification of the tax liability shown on your return.

If you accept a refund check, you still have the right to claim any additional refund and interest. File your claim within the applicable period of time. See *Amended Returns and Claims for Refund* later. If you do not accept a refund check, no more interest will be paid on the amount of the overpayment included in the check.

Interest on erroneous refund. All or part of any interest you were charged on an erroneous refund will generally be forgiven. Any interest charged for the period before demand for repayment was made will be forgiven unless you, or a person related to you, in any way caused the erroneous refund or the refund is more than $50,000.

For example, if you claimed a refund of $100 on your return, but the Internal Revenue Service made an error and sent you $1,000, you would not be charged interest for the time you held the $900 difference. You must, however, repay the $900 when requested by the IRS.

Offset Against Debts

If you are due a refund but have not paid certain obligations, all or part of your overpayment of tax may be used to pay all or part of the past-due amount. The obligations that may be offset by your refund are child and spousal support payments and federal debts such as student loans.

Joint return. When a joint return is filed, and only one spouse is obligated to pay the past-due amount, the spouse who is not obligated for the debt can be considered an ***injured spouse.*** An injured spouse may obtain a refund for his or her share of the overpayment that would otherwise be used to pay child and spousal support payments and federal nontax debts.

To be considered an injured spouse, you must:

1) File a joint return,
2) Have received income (such as wages, interest, etc.),
3) Have made payments (such as federal income tax withheld from wages or estimated tax payments),
4) Report the income and payments on the joint return, and
5) Have an overpayment, all or part of which may be applied against the past-due amount.

If you are an injured spouse, you can obtain your portion of the joint refund by filing Form 8379, *Injured Spouse Allocation,* and Form 1040X, *Amended U.S. Individual Income Tax Return,* at the same time that you file your federal income tax return. These forms can be attached to the front of the Form 1040 or 1040A. Write "**Injured Spouse**" at the top of Form 1040X.

For more information on filing a Form 1040X, see *Amended Returns and Claims for Refund* later in this chapter.

Change of Address

If you move you should always notify the IRS Service Center where you filed your last return of your new address.

If you move after filing your return and you are expecting a refund, you should notify both the post office serving your old address and the Service Center where you filed your return. This will help in forwarding your check to your new address.

Be sure to include your social security number (and the name and social security number of your spouse, if you filed a joint return) in any correspondence with the Internal Revenue Service.

Past-Due Refund

If you do not get your refund within 8 weeks after filing your return, call your Internal Revenue Service office or write to the Service Center where you filed your return. Be sure to include your name, address, and social security number (and the name and social security number of your spouse, if you filed a joint return) in any letter you send to the Internal Revenue Service.

Telephone service for tax refund information. You may be able to call a telephone number for your area to find out the status of your income tax refund. For details on how to use this telephone service, see how to use Tele-Tax in the instructions for Form 1040 or Forms 1040EZ and 1040A. Please wait 8 weeks after filing your 1988 tax return before using this service.

Amount You Owe

If you owe additional tax, you should pay it with your return. If you owe less than one dollar, you need not pay it.

If the Internal Revenue Service figures your tax, you will receive a bill for any tax that is due. You should pay this bill within 30 days.

If you do not pay your tax by the due date, you may have to pay a failure-to-pay penalty. See *Penalties,* later.

Interest will be charged on taxes not paid by their due date, even if you get an extension of time for filing.

For underpayments, the interest rates for 1988 are:

January 1 - March 31	11%
April 1 - September 30	10%
October 1 - December 31	11%

For overpayments, the interest rates for 1988 are:

January 1 - March 31	10%
April 1 - September 30	9%
October 1 - December 31	10%

The interest is compounded daily.

Tax shelter items. If you substantially underpay your tax because you claim an unallowable item relating to a tax shelter or a similar transaction, you may have to pay interest on the underpayment at an annual rate equal to 120% of the normal annual rate of interest.

Interest on penalties. Interest will also be charged on some penalties, including the failure-to-file penalty and the penalty for substantial understatement of liability. Interest is imposed on the penalty as of the due date of the return (including extensions) to the date of payment.

Compound interest on deficiency. If you are (or were) charged compounded interest on a deficiency for any period during which regular interest on the deficiency is suspended, you may be able to receive a refund of the compounded interest charged during that period. You can file a claim on Form 843, *Claim,* for such interest.

Interest due to IRS error or delay. All or part of any interest you were charged for a deficiency or payment can be forgiven if the interest is due to an error or delay by an officer or employee of the Internal Revenue Service in performing a ministerial act. This is a procedural or mechanical act that occurs during the processing of a taxpayer's case.

The interest can be forgiven only if you are not responsible in any important way for the error or delay and the IRS has notified you in writing of the deficiency or payment. For more information, see Publication 556.

If, by January 31, 1989, you file your tax return and pay your 1988 tax, you do not have to pay the 4th installment of your estimated tax.

Farmers and fishermen, who are only required to make one payment of estimated tax (by January 17, 1989), do not need to make that payment if they file Form 1040 and pay the tax in full for the 1988 calendar year by March 1, 1989.

Fiscal year taxpayers. If you are a fiscal year taxpayer, you have until the last day of the first month following the close of your fiscal year to file your tax return and pay the tax. (Farmers and fishermen have until the first day of the 3rd month.)

How to pay. If you pay by check or money order, make it out to *Internal Revenue Service.* Please write your social security number, form number, daytime telephone number, and tax year on the front of your check or money order. For example, during 1989 you file your Form 1040 for 1988 and you owe additional tax. Write your social security number, daytime telephone number, and *1988 Form 1040* on your check or money order. If you file an amended return (Form 1040X) for 1987 and you owe tax, write your social security number, daytime telephone number, and *1987 Form 1040X* on the front of your check or money order. Be sure to attach your payment to the front of your return.

Your tax is not paid until your check or money order is paid.

Do not mail cash with your return. If you pay cash at an Internal Revenue office, keep the receipt as part of your records.

Do not include any estimated tax payment in your check or money order. Instead mail it separately to the address shown in the Form 1040–ES Instructions. The address for mailing estimated tax payments may be different from the address where you send your tax return.

Gift to Reduce America's Debt

You may make a gift to reduce America's debt. If you wish to do so, enclose a ***separate*** check in the envelope with your income tax return and make it payable to *Bureau of the Public Debt.* You may be able to deduct this gift on next year's tax return if you itemize your deductions. Please do not add it to any tax you may owe. If you owe tax, include a separate check for that amount payable to *Internal Revenue Service.*

Penalties

To ensure that all taxpayers pay their fair share of taxes, the law provides penalties for failure to file returns or pay taxes as required.

If you do not file your return and pay your tax by the due date, you may have to pay a penalty. You may also have to pay a penalty if you substantially understate your tax, if you file a frivolous return, or if you fail to supply your social security number. These penalties are discussed below. If you fail to file a return when required or if you provide fraudulent information on your return, you may have to pay a civil fraud penalty or, in certain cases, you may be subject to criminal prosecution.

Filing late. If you do not file your return by the due date (including extensions), you may have to pay a ***failure-to-file*** penalty. The penalty is based on the tax not paid by the due date (without regard to extensions). The penalty is 5% for each month or part of a month that the return is late.

If both the failure-to-file and the failure-to-pay penalty (discussed later) apply in any month, the 5% failure-to-file penalty is reduced by the failure-to-pay penalty.

The failure-to-file penalty generally cannot be more than 25% of your tax. However, if your return is more than 60 days late, the penalty will not be less than $100 or 100% of the balance of tax due, whichever is less. You will not have to pay the penalty if you show that you had reasonable cause for not filing your return on time. See *Extensions of Time to File,* earlier.

Paying tax late. You will have to pay a ***failure-to-pay*** penalty of ½ of 1% of your unpaid taxes for each month, or part of a month, after the due date that the tax is not paid. If a notice of intent to levy is issued, the rate will increase to 1% at the start of the first month beginning at least 10 days after the day that the notice is issued. If a notice and demand for immediate payment is issued, the rate will increase to 1% at the start of the first month beginning after the day that the notice and demand is issued.

This penalty cannot be more than 25% of your unpaid tax. You will not have to pay the penalty if you can show that you had a good reason for not paying your tax on time. This failure-to-pay penalty is in addition to interest charges on late payments.

Penalty for substantial understatement of liability. If you substantially understate your tax liability, you may have to pay a penalty on any tax you owe that results from your understatement of tax. Understatement means the difference between the correct tax and the tax shown on your return. You are considered to have substantially understated your tax if the understatement is more than 10% of the correct tax or more than $5,000, whichever is larger.

Understatement may be reduced. If there is or was substantial authority to support the tax treatment of an item on your return that caused the understatement, the amount of the understatement may be reduced. This substantial authority exception applies to tax shelter items only if, in addition, the treatment of the item more likely than not was the correct treatment. Whether there is or was substantial authority depends on the facts and circumstances. Consideration will be given to court opinions, Treasury regulations, revenue rulings, and revenue procedures that involve the same or similar circumstances as yours. Except in the case of a tax shelter, the amount of the understatement may also be reduced if, on your return or a statement attached to your return, you have adequately disclosed the relevant facts affecting the tax treatment of the item shown on your return. You should use Form 8275, *Disclosure Statement Under Section 6661*, or your own statement that provides the same information as required on Form 8275, to make this disclosure.

Penalty for frivolous return. You may have to pay a penalty of $500 if you file a return that does not include enough information to figure the correct tax or a return that contains information that shows on its face that the tax shown on the return is substantially incorrect.

You will have to pay the penalty if you filed such a return due to a frivolous position on your part or because of a desire to delay or interfere with the administration of federal income tax laws. This includes any altering or striking out of the preprinted language above the space provided for your signature.

This penalty is in addition to any other penalty provided by law.

If you pay at least 15% of the penalty and file a claim for refund of the partial payment of the penalty within 30 days after the mailing of the assessment, you will not have to pay any additional amount until your case is settled.

Negligence penalty. If there is any underpayment of tax on your return that is due to negligence or disregard of rules or regulations, the following amounts will be added to your tax:

1) 5% of the entire underpayment, and
2) 50% of the interest payable on the part of the underpayment due to negligence for the period from the date such underpayment became payable to the earlier of the date it is paid or the date it is assessed.

The negligence penalty does not apply to any part of an underpayment that is subject to the fraud penalty.

Information returns. If you are required to file a tax return and you receive an information return, you may be required to report amounts shown on the information return on your tax return. Failure to report any of these amounts when required will be treated as due to negligence in the absence of clear and convincing evidence to the contrary.

Information returns include Form 1098, Form 1099, and Form 5498.

Fraud penalty. If there is any underpayment of tax on your return that is due to fraud, the following amounts will be added to your tax:

1) 75% of the underpayment due to fraud, and
2) 50% of the interest payable on the underpayment due to fraud for the period from the date such underpayment became payable to the earlier of the date it is paid or the date it is assessed.

If any part of an underpayment on a joint return is due to fraud, the fraud penalty will apply with respect to each spouse only to the extent that such underpayment is due to the fraud of that spouse.

Caution: As this publication was being prepared for print, Congress was considering legislation that would repeal the penalty of 50% of the interest on the underpayment due to negligence or fraud. Instead, it would make interest on the negligence and fraud penalties payable beginning on the last day for filing the return.

It would also restrict the negligence penalty, in cases of failure to include amounts shown on an information return, to the portion of the underpayment of tax due to such failure to report.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Penalty for failure to supply social security number. If you fail to include your and your dependent's social security numbers on any return, statement, or other document when required to, you will be subject to a penalty of $5 for ***each*** failure.

If you fail to include the social security number of another person, other than your dependent, when it is required on a return, statement, or other document (other than returns or statements related to interest, dividends, or patronage dividends), you will be subject to a penalty of $50 for ***each*** failure. You will also be subject to this $50 penalty if you fail to give your social security number to another person when it is required on a return, statement, or other document.

For example, if you have a bank account that pays you interest, you must give your social security number to the bank because it must be shown on the Form 1099–INT or other statement you will receive from the bank. If you do not give the bank your social security number, you will be subject to the penalty of $50. (You also may be subject to "backup" withholding of income tax. See Chapter 5.)

The maximum penalty is $100,000 for any calendar year. However, you will not have to pay the penalty if you have a reasonable cause for not giving your social security number.

Penalty for failure to furnish tax shelter registration number. A person who sells (or otherwise transfers) an interest in a tax shelter must give you the tax shelter registration number. If you claim any deduction, credit, or other tax benefit by reason of the tax shelter, you must attach Form 8271, *Investor Reporting of Tax Shelter Registration Number*, to your return to report this number. You will have to pay a penalty of $250 for each failure to report a tax shelter registration number. The penalty can be excused if you have a reasonable cause for not reporting the number.

Amended Returns and Claims for Refund

If, after you have filed your return, you find that you did not report some income, you claimed deductions or credits you should not have claimed, or you did not claim deductions or credits you could have claimed you should correct your return. If you need a copy of your return, see *Keep copies of tax returns* under *Recordkeeping*, later in this chapter.

Form 1040X, *Amended U.S. Individual Income Tax Return*, is the form to use to correct the Form 1040, Form 1040A, or Form 1040EZ you have already filed.

Completing the return. On Form 1040X, write your income, deductions, and credits as you originally reported them on your Form 1040, Form 1040A, or Form 1040EZ, the changes you are making, and the corrected amounts. Then figure the tax on the corrected amount and the amount you owe or your refund. If you owe tax, you must pay the full amount with Form 1040X. The tax owed will not be subtracted from any refund you have not yet received or from any amount you had credited to your 1989 estimated tax. A refund will be sent separately from any refund from your original return.

If you are filing as an injured spouse, you must file a Form 8379 with your Form 1040X. See *Refunds*, earlier in this chapter.

Filing the return. After you finish your Form 1040X, check it to be sure that it shows all the information asked for. Do not forget to show the year of your original return and the explanations for all changes you made. Be sure to attach any forms or schedules needed to explain your changes. Mail your Form 1040X to the Internal Revenue Service Center serving the area where you now live (as shown in the instructions to the form).

A separate form must be filed for each tax year or period involved.

Time for filing a claim for refund. Generally, you must file your claim for a credit or refund within 3 years from the date your original return was filed or within 2 years from the date the tax was paid, whichever is later. If you do not file a claim within this period, you may no longer be entitled to a credit or a refund. If the due date for filing a return or a claim for a credit or refund is a Saturday, Sunday, or legal holiday, the return or claim is considered timely filed if it is filed on the next business day. Returns filed before the due date are considered to have been filed on the due date. This is true even if the due date is a Saturday, Sunday, or legal holiday.

Limit on amount of refund. If you file your claim within 3 years after the date you filed your return, the credit or refund may not be more than the part of the tax paid within the 3 years (plus any extension of time for filing your return) before you filed the claim.

Example 1. You made estimated tax payments of $500 and got an automatic extension of time to August 15, 1985, to file your 1984 income tax return. When you filed your return on that date, you paid an additional $200 tax. Three years later, on August 15, 1988, you file an amended return and claim a refund of $700. Because you filed within the 3 years plus the 4-month extension period, you could get a refund of $700.

Example 2. The situation is the same as in Example 1, except you filed your return on October 31, 1985, 2½ months after the extension period ended. You paid an additional $200 on that date. Three years later, on October 25, 1988, you file an amended return and claim a refund of $700. Although you filed your claim within 3 years from the date you filed your original return, the refund is limited to $200. The estimated tax of $500 was paid before the 3 years plus the 4-month extension period.

If you file a claim after the 3-year period, but within 2 years from the time you paid the tax, the credit or refund may not be more than the tax you paid within the 2 years immediately before you file the claim.

Example. You filed your 1984 tax return on April 15, 1985. You paid taxes of $500. On November 3, 1986, after an examination of your 1984 return, you had to pay an additional tax of $200. On May 2, 1988, you file a claim for a refund of $300. However, your refund will be limited to the $200 you paid during the 2 years immediately before you filed your claim.

Exceptions for special types of refunds. If you file a claim for one of the items listed below, the dates and limits discussed earlier (under *Time for filing a claim for refund)* may not apply. These special types of refunds are:

- A bad debt,
- A worthless security,
- Foreign tax paid or accrued,
- Net operating loss carryback,
- Carryback of certain tax credits, or
- A claim based on an agreement with the Service extending the period for assessment of tax.

Processing claims for refund. Claims are usually processed shortly after they are filed. Your claim may be accepted as filed or may be subject to examination. If a claim is examined, the procedures are the same as in the examination of a tax return.

However, if you are filing a claim for a credit or refund based solely on contested income tax or on estate tax or gift tax issues considered in previously examined returns and do not want to appeal within the Service, you should request in writing that the claim be immediately rejected. A notice of claim disallowance will then be promptly sent to you. You have 2 years from the date of mailing of the notice of disallowance to file a refund suit in the United States District Court having jurisdiction or in the United States Claims Court.

Reduced refund. Your refund may be reduced by an additional tax liability that has been assessed against you.

Also, your refund may be reduced by amounts you owe for past-due child support or as debts to another federal agency. The Service will notify you if this happens. The refund procedures discussed in this chapter will not be available to you for such a reduction.

Note. If your return is changed for any reason, it may affect your state income tax liability. This includes changes made as a result of an examination of your return by the Internal Revenue Service. Contact your state tax agency for more information.

Where to File

Use the addressed envelope that came with your return. If you do not have an addressed envelope or if you moved during the year, mail your return to the Internal Revenue Service Center for the area where you now live. The street address of the Service Center is not needed. A list of Service Center addresses is shown on the back cover.

Recordkeeping

You must keep records so that you can prepare a complete and accurate income tax return. The law does not require any special form of records. However, you should keep all receipts, cancelled checks, and other evidence to prove amounts you claim as deductions or credits.

If you file a claim for refund, you must be able to prove by your records that you have overpaid your tax.

You must keep your records for as long as they are important for any Internal Revenue law.

Keep records that support an item of income or a deduction appearing on a return until the period of limitations for the return runs out (a period of limitations is the limited period of time after which no legal action can be brought). Usually this is 3 years from the date the return was due or filed, or 2 years from the date the tax was paid, whichever date is later. However, if an amount of income that should have been reported on your return was not reported, and it is more than 25% of the income shown on the return, the period of limitations does not run out until 6 years after the return was filed. If a return is false or fraudulent with intent to evade tax, or if no return is filed, an action can generally be brought at any time.

In property transactions, sometimes the basis of new or replacement property depends on the basis of the old property. See Chapter 15. Keep the records of transactions relating to the basis of property for as long as they are important in figuring the basis of the original or replacement property.

Keep copies of tax returns you have filed and the tax return package as part of your records. They may be helpful in amending filed returns or preparing future ones.

If you need a copy of a prior year tax return, you may obtain it from the Internal Revenue Service. Use Form 4506, *Request for Copy of Tax Form.* A charge for a copy of a return must be paid with Form 4506. Contact your local IRS office if you need a transcript of your tax account. The following information will be provided from your account:

- Name and social security number,
- Type of return filed,
- Marital status,
- Tax shown on return,
- Adjusted gross income,
- Taxable income,
- Self-employment tax, and
- Number of exemptions.

2. Filing Status

The rate at which your income is taxed depends, in part, on your **filing status**. There are five filing statuses:

- Single
- Married filing jointly
- Married filing separately
- Head of household
- Qualifying widow or widower

Your filing status is used in determining your filing requirements, standard deduction, and correct tax. It is also important in determining whether you are eligible to claim certain other deductions and credits. See *Individuals—In General,* in Chapter 1 for the filing requirements. See *Standard Deduction* in Chapter 22 for information on the standard deduction. Your correct tax is determined by using the column in the Tax Table or the Tax Rate Schedule that applies to your filing status.

You must indicate your filing status by checking the appropriate box on lines 1 through 5 of Form 1040 or Form 1040A. There are no boxes for filing status on Form 1040EZ because you must be single to file that form.

Married taxpayers. You and your spouse may be able to file a joint return or you may file separate returns.

Head of household or qualifying widow or widower. If you are single, separated, divorced, or widowed, you may be able to file as a head of household. If you are a qualifying widow or widower with a dependent child, you may be able to use the joint tax rates.

Single taxpayers. You must file as single if, on the last day of your tax year, you are unmarried or separated from your spouse either by divorce or separate maintenance decree and you do not qualify for another filing status.

State law governs whether you are married, divorced, or legally separated under a decree of separate maintenance.

Single

Your filing status is ***single*** if you are unmarried or separated from your spouse either by a divorce or separate maintenance decree, and do not qualify to file as head of household. However, if you were considered married for part of the year and lived in a community property state (defined under *Married Filing Separately),* special rules may apply in determining your income and expenses. See Publication 555, *Community Property and the Federal Income Tax,* for more information.

You may file Form 1040EZ (if you have no dependents), Form 1040A, or Form 1040. If you file Form 1040A or Form 1040, show your filing status by checking the box on line 1. Use the *Single* column of the Tax Table, or *Schedule X* of the Tax Rate Schedules, to figure your tax.

If you file as single, you do not qualify for the earned income credit or the credit for child and dependent care expenses.

Married Filing Jointly

You may elect to choose ***married filing jointly*** as your filing status if you are married and both you and your spouse agree to file a joint return. On a joint return, you report your combined income and deduct your combined allowable expenses.

If you and your spouse decide to file a joint return, your tax may be lower than the other filing statuses, your standard deduction (if you do not itemize deductions) may be higher, and you may qualify for tax benefits that do not apply to other filing statuses. You may file a joint return even if one of you had no income or deductions. If you and your spouse each have income, you may want to figure your tax both on a joint return and on separate returns (using the filing status of ***Married filing separately***) to see which method gives you the lower tax.

If you decide to file as married filing jointly, you may use Form 1040A or Form 1040. You select your filing status by checking the box on line 2 of either form. You figure your tax by using the *Married filing jointly* column of the Tax Table, or *Schedule Y-1* of the Tax Rate Schedules.

Married Taxpayers

You are considered married for the whole year if on the last day of your tax year you are:

1) Married and living together as husband and wife, or
2) Living together in a ***common law marriage*** that is recognized in the state where you now live or in the state where the common law marriage began, or
3) Married and living apart, but not legally separated under a decree of divorce or separate maintenance, or
4) Separated under an interlocutory (not final) decree of divorce. For purposes of filing a joint return, you are not considered divorced.

If your spouse died during the year, you are considered married for the whole year.

If you did not remarry before the end of the tax year, you may file a joint return for yourself and your deceased spouse. See Chapter 4. You also may be entitled, for the next 2 years, to the special benefits for qualifying widows and widowers, described later.

If you remarried before the end of the tax year, you may file a joint return with your new spouse. Your deceased spouse's filing status is married filing separately.

Married persons living apart. Even though you are not divorced or legally separated, if you live apart from your spouse and meet certain tests, you may be considered ***unmarried,*** and may file as head of household instead of as married filing separately. See *Head of Household,* later. If you qualify to file as head of household, your standard deduction will be higher, your tax may be lower, and you may be able to claim the earned income credit. See *Earned Income Credit* in Chapter 35.

If you are divorced under a final decree by the last day of the year, you are considered single for the whole year.

Exception. If you obtain a divorce in one year for the sole purpose of letting you and your spouse file tax returns as unmarried individuals, and at the time of divorce you intended to and did remarry each other in the next tax year, you and your spouse must file as married individuals.

If you obtain a decree of annulment, which holds that no valid marriage ever existed, you must file as single or head of household, whichever applies, for that tax year. You also must file amended returns claiming single or head of household status for all tax years affected by the annulment that are not closed by the statute of limitations for filing a tax return. The statute of limitations generally does not close until 3 years after your original return was filed. For information on when and how to file an amended return, see *Amended Returns and Claims for Refund* in Chapter 1.

Filing a Joint Return

Both you and your spouse must include all your income, exemptions, and deductions on your joint return.

Both of you must use the same accounting period, but you may use different accounting methods. See *Accounting Periods and Methods* in Chapter 1.

Both of you may be held responsible, jointly and individually, for the tax and any interest or penalty due on your joint return. One spouse may be held responsible for all the tax due even though all the income was earned by the other spouse.

Exception. You may not have to pay the tax, interest, and penalties on a joint return if you establish that you did not know, and had no reason to know, that there was a substantial understatement of tax that resulted because your spouse:

1) Omitted a gross income item, or
2) Claimed a deduction, credit, or property basis in an amount for which there is no basis in fact or law.

When the facts and circumstances are considered, it also must be inequitable to hold you liable for the tax due. One factor is whether you significantly benefited, directly or indirectly, from your spouse's actions. Normal support is not a significant benefit.

This exception applies only if your spouse's action resulted in an understatement of tax of more than $500. To the extent the understatement is attributable to claiming an incorrect deduction, credit, or property basis, this exception is available only if your liability for tax, interest, and penalties is more than 10% of your adjusted gross income for the most recent tax year before the deficiency notice was mailed, if that income was $20,000 or less (25% if your adjusted gross income is more than $20,000). If you remarried before the end of that most recent year, include the income of your new spouse to see if the exception applies to you.

For purposes of this exception, community property rules do not apply to items of gross income (other than gross income from property).

Divorced taxpayer. You may still be held jointly and individually responsible for any tax, interest, and penalties due on a joint return filed before your divorce. This responsibility applies even if your divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns.

If you and your spouse file separately, you are responsible only for the tax due on your own return.

Signing a joint return. You must sign your return. For a return to be considered a joint return, both husband and wife must sign the return. If your spouse died before signing the return, see *Signing the return* in Chapter 4.

If your spouse is away from home for any reason, you should prepare the return, sign it, and send it to your spouse to sign so that it can be filed on time. If you or your spouse are out of the country at the time your return is due, see *If you file a joint return* under *Extensions—Special Rule* in Chapter 1.

If your spouse cannot sign because of disease or injury and tells you to sign, you may sign your spouse's name in the proper space on the return followed by the words "By (your name), Husband (or Wife)." Be sure to also sign in the space provided for your signature. Attach a dated statement, signed by you, to your return. The statement should include: the name of the return you are filing; the tax year; the reason your spouse cannot sign; and that your spouse has agreed to your signing for him or her.

If you are the guardian of your spouse who is mentally ill, you may sign the return for your spouse as guardian.

If your spouse cannot sign the joint return for any other reason, you may sign for your spouse only if you are given a valid power of attorney (a legal document giving you permission to act for your spouse). Attach the power of attorney to your tax return. You may use Form 2848, *Power of Attorney and Declaration of Representative.*

Nonresident alien and dual-status alien. A joint return cannot be made if either spouse is a nonresident alien at any time during the tax year. However, if at the end of the year you were a nonresident alien or dual-status alien married to a U.S. citizen or resident, you may be able to file a joint return. If you do file a joint return, you and your spouse must agree to be taxed on your combined worldwide income. See Publication 519, *U.S. Tax Guide for Aliens.*

Married Filing Separately

You may choose ***married filing separately*** as your filing status if you are married. This method may benefit you if you want to be responsible only for your own tax or if this method gives you less tax than a joint return. You may be required to choose this filing status if you and your spouse do not agree to file a joint return.

You should figure your tax both ways (on a joint return and on separate returns) to make sure you are using the method that results in lower combined tax. However, you generally will pay more combined tax on separate returns than you would on a joint return. This is because the tax rate is higher for married persons filing separately.

If you file separate returns, you each report only your income, exemptions (you may not split an exemption), credits, and deductions on your individual returns. You may file a separate return, and claim an exemption for your spouse, if your spouse had no gross income. However, if your spouse had any gross income, you may not claim an exemption for him or her on your separate return.

If you file married filing separately, you may use Form 1040A or Form 1040. You select your filing status by checking the box on line 3 of either form. You must also write your spouse's social security number and full name in the spaces provided. You figure your tax by using the *Married filing separately* column of the Tax Table or *Schedule Y-2* of the Tax Rate Schedules.

Separate Returns

Special rules apply when filing a separate return.

Deductions on separate returns. If you and your spouse file separate returns and one of you itemizes deductions, the other should itemize deductions, since he or she cannot take the standard deduction. However, see *Married persons living apart,* earlier.

If you live in a community property state. If you live in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin (which is considered a community property state for federal income tax purposes) and file separately, your income may be separate income or community income for income tax purposes. See Publication 555, *Community Property and the Federal Income Tax*.

If you file a separate return:

- You cannot take the credit for child and dependent care expenses in most instances.
- You cannot take the earned income credit.
- If you lived with your spouse at any time in 1988—
    a) You cannot take the credit for the elderly or the disabled.
    b) You may have to include in income up to one-half of any social security benefits (including any equivalent railroad retirement benefits) you received in 1988.

Joint Return After Separate Returns

You may change your filing status by filing an amended return using Form 1040X, *Amended U.S. Individual Income Tax Return*.

If you or your spouse (or each of you) files a separate return, you may change to a joint return any time within 3 years from the due date of the separate return or returns. This does not include any extensions. A separate return includes a return filed by you or your spouse claiming married filing separately, single, or head of household filing status. If the amount paid on your separate returns is less than the total tax shown on the joint return, you must pay the additional tax due on the joint return when you file it.

If you file a joint return, you may not, after the due date of the return, choose to file separate returns for that year.

Head of Household

Your filing status is ***head of household*** if you are unmarried or considered unmarried on the last day of the year and pay more than half the cost of keeping up a home for you and a dependent. The rules to qualify for head of household are explained below.

If you qualify to file as head of household, your tax rate will be lower than the rates for single or married filing separately, and you may qualify for the earned income credit and the child care credit. You also receive a higher standard deduction than if you file as single or married filing separately (Note: You can only claim a standard deduction amount if you do not itemize deductions).

Note. If you were considered married for part of the year and lived in a community property state (defined under *Married Filing Separately*), special rules may apply in determining your income and expenses. See Publication 555 for more information.

If you file as head of household, you may use either Form 1040A or Form 1040. Indicate your choice of this filing status by checking the box on line 4 of either form. If you have a dependent who qualifies you as head of household but you cannot claim an exemption for that person, enter the dependent's name in the space provided on line 4 of your Form 1040A or Form 1040. You figure your tax by using the *Head of a household* column of the Tax Table or *Schedule Z* of the Tax Rate Schedules.

You may be eligible to file as head of household if you were unmarried or were considered unmarried on the last day of the year. You must have paid more than half the cost of keeping up a home that was the main home for more than half the year for you and any of the following:

1) Your child, grandchild, stepchild, or adopted child who is:
    a) Single. This child does not have to be your dependent.
    b) Married. This child must qualify as your dependent unless you state in writing to the noncustodial parent that he or she may claim an exemption for the dependent, or, the noncustodial parent provides at least $600 support for the dependent and claims an exemption for the dependent under a pre-1985 divorce or separation agreement.
2) Any relative listed below whom you can claim as a dependent. However, if your dependent parent does not live with you, a special rule applies. See *Father or mother* later.

Parent
Grandparent
Brother
Sister
Stepbrother
Stepsister
Stepmother
Stepfather
Mother-in-law
Father-in-law

Brother-in-law
Sister-in-law
Son-in-law
Daughter-in-law, or
If related by blood:
  Uncle
  Aunt
  Nephew
  Niece

You do not qualify as a head of household if you can only claim a relative in (1b) or (2), or a parent who does not live with you, as a dependent under a multiple support agreement.

You are related by blood to an uncle or aunt if he or she is the brother or sister of your father or mother.

You are related by blood to a nephew or niece if her or she is the child of your brother or sister.

Foster child. You qualify as head of household if you meet the rules above and you can claim your foster child as a dependent.

Father or mother. If your dependent parent does not live with you, you must pay more than half the cost of keeping up a home that was the main home for the ***entire*** year for your mother or father, in order for you to be eligible to file as head of household. You are keeping up a main home for your dependent father or mother if you pay more than half the cost of keeping your parent in a rest home or home for the elderly.

You are considered unmarried if you meet all of the following tests:

1) You file a separate return, and
2) You paid more than half the cost of keeping up your home for the tax year, and
3) Your spouse did not live in your home during the last 6 months of the tax year, and
4) Your home was, for more than half the year, the main home of your child, stepchild, or adopted child whom you can claim as a dependent. However, if you cannot claim your child as a dependent, you can still meet this test if:
    a) You state in writing to the noncustodial parent that he or she may claim an exemption for the child, or
    b) The noncustodial parent provides at least $600 support for the dependent and claims an exemption for the dependent under a pre-1985 divorce or separation agreement.

A foster child or a child placed with you for adoption may be considered your child under certain conditions. See Chapter 3.

Written declaration. Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, may be used to make the written declaration that allows a noncustodial spouse to claim a dependent.

Nonresident alien spouse. You are considered unmarried for head of household purposes if your spouse was a nonresident alien at any time during the year, and you do not file a joint return as discussed earlier under *Nonresident alien and dual-status alien*. Your spouse is not considered your relative. You must have another qualifying relative and meet the other tests to be eligible to file as a head of household. However, you are considered married if you have chosen to treat your spouse as a resident alien. See Publication 519.

Dual-status and nonresident alien taxpayers may not claim head of household status.

Qualifying Widows and Widowers

If your spouse died in 1988, you may use married filing jointly as your filing status for 1988 if you would otherwise qualify. See *Married Filing Jointly* earlier.

If your spouse died in 1986 or 1987, and you have not remarried, you may be able to use ***Qualifying widow(er)*** as your filing status. You must, however, meet all of the following tests:

1) You were entitled to file a joint return with your spouse for the year your spouse died (it does not matter whether you actually filed a joint return), and
2) You did not remarry before the end of the tax year, and
3) You have a child, stepchild, adopted child, or foster child who qualifies as your dependent for the year, and
4) You paid more than half the cost of keeping up your home, which is the main home of that child for the entire year except for temporary absences. See *Keeping Up a Home*, discussed later.

Example. John Doe's wife died in 1986. John has not remarried. He has continued during 1987 and 1988 to keep up a home for himself and his dependent child. For 1986 he was entitled to file a joint return for himself and his deceased wife. For 1987 and 1988 he may file as qualifying widower because he is a widower with a dependent child. After 1988 he may file as head of household if he qualifies.

This filing status entitles you to the same tax benefits as married filing jointly, including the lower tax rates, the highest standard deduction amount (Note: You can only claim a standard deduction amount if you do not itemize deductions), and other deductions and tax credits.

Figuring your tax. If your spouse died in 1986 or 1987 and you meet the four tests above, you can file as a qualifying widow or widower on your 1988 tax return.

Indicate your filing status by checking the box on line 5 of ***either*** Form 1040A or Form 1040 (you may not file Form 1040EZ). Write the year your spouse died in the space provided on line 5 of Form 1040A or Form 1040. You figure your tax by using the *Married filing jointly* column of the Tax Table or *Schedule Y-1* of the Tax Rate Schedules.

Keeping Up a Home

You are keeping up a home only if you pay ***more than half*** the cost of its upkeep.

Include such costs as rent, mortgage interest, taxes, insurance on the home, repairs, utilities, domestic help, and food eaten in the home.

Do not include the cost of clothing, education, medical treatment, vacations, life insurance, transportation, the rental value of a home you own, or the value of your services or those of a member of your household.

Include or exclude these expenses only to figure whether you are keeping up a home. Do not claim them as deductions on your return unless they are otherwise deductible. See Chapter 3 for expenses you can use to figure if a person qualifies as your dependent.

State AFDC (Aid to Families with Dependent Children) payments you use to keep up your home do not count as amounts you paid. Include these amounts in the total cost of keeping up your home to figure if you paid more than half.

Temporary absences. Do not include absences for vacation, sickness, school, or military service in determining the time your child or relative actually lived in your home.

Death or birth. If the dependent who qualifies you to use a particular filing status is born or dies during the year, you still may be able to claim that filing status. You must have provided more than half the cost of keeping up a home, which was the dependent's main home, during the entire part of the year he or she was alive. For head of household status, the home must be your dependent's main home for more than half the year, or, if less, the period during which your dependent lived.

Example. You are unmarried. Your mother lived in an apartment by herself. She died on September 2, 1988. The cost of the upkeep of her apartment for the year until her death was $6,000. You paid $4,000 and your brother paid $2,000. Your brother made no other payments towards your mother's support. Your mother had no income. Since you paid more than half the cost of keeping up the apartment for your mother from January 1, 1988, until her death, and she qualifies as your dependent, you may file as a head of household.

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3. Personal Exemptions and Dependents

Important Changes for 1988

You are allowed a $1,950 deduction for each exemption to which you are entitled for 1988.

Phaseout of exemptions. Beginning in 1988, you may lose the benefit of part or all of your exemptions, if you have taxable income of more than $89,560.

Exemptions

Exemptions reduce your taxable income. Each exemption you claim is worth a certain amount that is set by law. For 1988, that amount is **$1,950**. For 1989, each exemption will be $2,000.

There are two types of exemptions: personal exemptions and dependency exemptions. While they are both worth the same amount ($1,950 in 1988), different rules, discussed later, apply to each type.

You may usually claim exemptions for yourself, your spouse, and each person you can claim as a dependent. Therefore, if you are entitled to two exemptions for 1988, you would deduct $3,900 ($1,950 × 2). If you are entitled to claim an exemption for a dependent, such as your child, on your tax return, that dependent cannot claim a personal exemption on his or her own tax return.

Beginning in 1988, however, you may lose the benefit of part or all of your exemptions if you have a high taxable income. If your taxable income is more than $89,560, see *Phaseout of Exemptions* later, for more information.

How to claim exemptions. The manner in which you claim an exemption depends on which tax return you file.

If you file Form 1040EZ because you are single, you may claim no more than one exemption for yourself. You enter *$1,950* on line 6 unless someone else can claim your exemption. If that is the case, you enter *0* on line 6.

If you file Form 1040A, you complete lines 6a through 6e with the requested information. Follow the Form 1040A instructions. You show the total number of exemptions you claim in the box on line 6e. Also complete line 18 by multiplying the amount in the box on line 6e by $1,950.

If you file Form 1040, you show your exemptions by completing lines 6a through 6e with all the information requested. Follow the instructions for your Form 1040. On line 36, you multiply your total exemptions, as shown on line 6e, by $1,950 and enter the result.

Personal Exemptions

You are generally allowed one exemption for yourself, and if you are married, one exemption for your spouse. These are called personal exemptions.

Your Own Exemption

You may take one exemption for yourself unless you can be claimed as a dependent by another taxpayer. If another taxpayer is entitled to claim you as a dependent, you may not take an exemption for yourself. This is true even if the other taxpayer does not actually claim your exemption.

Exemptions for age and blindness. The exemptions previously allowed for age (65 or older) and blindness have been replaced by a higher standard deduction. For more information, see Chapter 22.

Exemption for Your Spouse

Your spouse is never considered your dependent. You are permitted one exemption for your spouse only because you are married.

Joint return. If your spouse had any gross income, as defined in Chapter 1, you may take your spouse's exemption only if you and your spouse file a joint return.

Separate return. If you file a separate return, you may claim the exemption for your spouse only if your spouse had ***no gross income*** and was not the dependent of another taxpayer. This is true even if your spouse is a nonresident alien.

Dependent of another. If another taxpayer is entitled to claim your spouse as a dependent, you cannot claim an exemption for your spouse. This is true even if the other taxpayer does not actually claim your spouse's exemption.

If your spouse died during the year, you may generally claim your spouse's exemption as just explained above.

If you remarried during the year, you may not take an exemption for your deceased spouse.

If you are a surviving spouse without gross income and you remarry, you may be claimed as an exemption on both the final separate return of your deceased spouse and the separate return of your new spouse whom you married in the same year. If you file a joint return with your new spouse, you may be claimed as an exemption only on that return.

If you obtain a final decree of divorce or separate maintenance by the end of the year, you may not take your former spouse's exemption. This rule applies even if you provided all of your former spouse's support.

Exemptions for Dependents

You are allowed one exemption, $1,950 in 1988, for each person you can claim as a dependent. This is called a dependency exemption.

A person is your dependent if all ***five*** of the dependency tests, discussed below, are met. You can take one exemption for each dependent. You may take an exemption for your dependent child even if your child files a return. However, see *Joint Return Test,* later in this chapter.

If your dependent files a tax return, that dependent cannot claim his or her own exemption. For information on tax returns for children under age 14, see Chapter 32.

If your child was born alive during the year, and the dependency tests are met, you may take the full exemption. The child is considered to have lived with you for 12 months. This is true even if the child lived only for a moment. Whether your child was born alive depends on state or local law. There must be proof of a live birth shown by an official document, such as a birth certificate. You cannot claim an exemption for a stillborn child.

Expenses you incurred for an induced abortion do not qualify as items of support for a child born alive during the tax year.

If your dependent died during the year and otherwise qualified as your dependent, you may take his or her exemption. The dependent is considered to have lived with you for 12 months.

Example. Your dependent mother died on January 15. You may take a full exemption for her on your return.

Housekeepers, maids, or servants who work for you may not be claimed as dependents.

Dependency tests. The following five tests must be met for a person to be your dependent:

Member of Household or Relationship Test
Citizenship Test
Joint Return Test
Gross Income Test
Support Test

Member of Household or Relationship Test

To meet this test, a person must live with you for the entire year as a member of your household or be related to you, as discussed later.

Temporary absences. A person who is temporarily absent from your home for vacation, school, or sickness will meet the member of household test.

If the person is placed in a nursing home for an unspecified period of time to receive constant medical care, the absence is considered temporary.

Death or birth. A person who died during the year, but was a member of your household until death, will meet the member of household test. The same is true for a child who was born during the year and was a member of your household for the rest of the year, or would have been a member except for any required hospital stay following birth.

A person does not meet the member of household test if at any time during your tax year the relationship between you and that person violates local law.

A person related to you in any of the following ways does not have to live with you or be a member of your household to meet this test.

Your child, grandchild, great grandchild, etc. (a legally adopted child is considered your child),
Your stepchild,
Your brother, sister, half brother, half sister, stepbrother, or stepsister,
Your parent, grandparent, or other direct ancestor, but not foster parent,
Your stepfather or stepmother,
A brother or sister of your father or mother,
A son or daughter of your brother or sister,
Your father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law.

Any of the above relationships that were established by marriage are not ended by death or divorce.

Adoption. Before legal adoption, a child is considered to be your child if he or she was placed with you for adoption by an authorized agency and was a member of your household. If the child was not placed with you by such an agency, the child will meet this test only if he or she was a member of your household for your entire tax year.

Foster child. A foster child qualifies as your dependent if the child lives with you as a member of your household for the entire year, and the child meets the other four dependency tests. This includes the support test.

However, if a state, or one of its political subdivisions, or a tax-exempt child-placing agency, makes payments to you as a foster parent, you may not take the child as your dependent. Your expenses are incurred on behalf of the agency that made payments to you. Expenses you incur in excess of nontaxable payments you receive are allowed as charitable contributions. If you receive taxable payments, your expenses may be deductible as business expenses. See *Foster-care providers* in Chapter 13 and *Foster parents* in Chapter 26.

Cousin. Your cousin will meet this test only if he or she lives with you as a member of your household for the entire year. A cousin is a descendant of a brother or sister of your father or mother.

Joint return. If you file a joint return, you need not show that a dependent is related to both you and your spouse. And you need not show that a dependent is related to the spouse that provides support. For example, your spouse's uncle who receives more than half his support from you may be your dependent, even though he does not live with you.

If you and your spouse file ***separate returns,*** your spouse's uncle can be your dependent only if he is a member of your household and lives with you for your entire tax year.

Citizenship Test

To meet the citizenship test, a person must be a U.S. citizen, resident, or national, or a resident of Canada or Mexico for some part of the calendar year in which your tax year begins.

Children usually are citizens or residents of the country of their parents.

If you were a U.S. citizen when your child was born, the child may be recognized as a U.S. citizen for tax purposes although the other parent was a nonresident alien and the child was born in a foreign country. If so, and if the other dependency tests are met, the child is your dependent and you may take the exemption, even though the child lives abroad with the nonresident alien parent.

If you are a U.S. citizen living abroad and have legally adopted a child who is not a U.S. citizen or resident, and if the other dependency tests are met, the child is your dependent and you may take the exemption if your home is the child's main home and the child is a member of your household for your entire tax year.

Foreign students brought to this country under a qualified international education exchange program and placed in American homes for a temporary period generally are not U.S. residents, and do not meet the citizenship test. They may not be claimed as dependents. However, if you provided a home for a foreign student, you may be able to take a charitable contribution deduction. See *Student Living With You* in Chapter 26.

Joint Return Test

Even if the other dependency tests are met, you are not allowed an exemption for your dependent if he or she files a joint return.

Example. You supported your daughter for the entire year while her husband was in the armed forces. The couple files a joint return. Even though all the other tests are met, you may not take an exemption for your daughter.

Exception. You may take an exemption for your married dependent if neither the dependent nor the dependent's spouse is required to file a return, but they file a joint return to claim a refund of tax withheld and no tax liability exists for either spouse on separate returns. Your married dependent may not claim his or her own exemption.

Example. Your son and his wife each had less than $1,000 gross income. Neither is required to file a tax return. Taxes were withheld from their income, so they file a joint return to get a refund. You are allowed exemptions for your son and daughter-in-law, if the other dependency tests are met.

Gross Income Test

Generally, you may not take an exemption for a dependent if that person had gross income of $1,950 or more for the year. This test does not apply if the person is your child and is either under age 19 or a student, as discussed later.

If you file on a fiscal year basis, the gross income test applies to the calendar year in which your fiscal year begins.

Gross income is all income in the form of money, property, and services that is not exempt from tax.

In a manufacturing, merchandising, or mining business, gross income is the total net sales minus the cost of goods sold, plus any miscellaneous income from the business.

Gross receipts from rental property are gross income. You may not deduct taxes, repairs, etc., to determine the gross income from rental property.

Gross income includes a partner's share of the gross, not a share of the net, partnership income.

Tax-exempt income, such as certain social security payments, is not included in gross income. See *Items Not Taxed* in Chapter 13.

Gross income also includes all unemployment compensation and certain scholarships. Scholarships received by degree candidates, which are used for tuition and fees, and books and equipment required for particular courses, are not included in gross income. For more information, see Chapter 13.

Gross income does not include income received by a permanently and totally disabled individual at a sheltered workshop. The availability of medical care must be the main reason the individual is at the workshop, and the income must come solely from activities at the workshop that are incident to this medical care. A sheltered workshop is a school operated by certain tax-exempt organizations, or by a state, a U.S. possession, a political subdivision of a state or possession, the United States, or the District of Columbia, that provides special instruction or training designed to alleviate the disability of the individual.

If your child is under 19 at the end of the year, the gross income test does not apply. Your child may have any amount of income and still be your dependent, if the other dependency tests are met.

Example. Marie Grey, 18, earned $2,400. Her father provided more than half her support. Marie may be claimed as a dependent because the gross income test does not apply and the other dependency tests were met.

Your child is your son, stepson, daughter, stepdaughter, a legally adopted child, or a child who was placed with you by an authorized placement agency for your legal adoption. A foster child who was a member of your household for your entire tax year is also considered your child. See *Foster child,* earlier.

If your child is a student, the gross income test does not apply. The child's age does not matter. You may claim your child as a dependent if the other dependency tests are met.

To qualify as a student your child must be, during some part of each of 5 calendar months during the calendar year (not necessarily consecutive):

1) A full-time student at a school that has a regular teaching staff, course of study, and regularly enrolled body of students in attendance, or
2) A student taking a full-time, on-farm training course. The course has to be given by a school or a state, county, or local government. The school must have a regular teaching staff, course of study, and regularly enrolled body of students in attendance.

A ***full-time student*** is one who is enrolled for the number of hours or courses the school considers to be full-time attendance.

The term ***school*** includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade, and mechanical schools. The term "school" does not include on-the-job training courses, correspondence schools, and night schools.

Example. James, 22, attends college as a full-time student. During the summer, James earned $2,000, which he spent for his support. His parents provided more than $2,000 toward his support and the other dependency tests were met. On their return, they may claim the exemption for James as a dependent child who lived with them.

Vocational high school students who work on "co-op" jobs in private industry as a part of the school's prescribed course of classroom and practical training are considered full-time students.

Night school. Your child is not a full-time student while attending school only at night. However, full-time attendance at a school may include some attendance at night as part of a full-time course of study.

Correspondence and employee training courses. Your child does not qualify as a full-time student by taking correspondence courses, employee training courses, or similar programs.

Support Test

You must provide more than half of a person's total support during the calendar year to meet the support test. You figure whether you have provided more than half by comparing the amount you contributed to the person's support with the entire amount of support received from all sources. This amount includes the person's own funds used for support. You may not include in your contribution any part of the support that is paid for by your child with the child's own wages, even if you pay the wages. See *Total Support,* discussed later. For exceptions to the support test, see *Multiple Support Agreement* and *Support Test for Divorced or Separated Parents,* later.

Amounts that a person receives are not support unless they are actually spent for support.

Example. Your mother received $2,400 in social security benefits and $300 in interest. She paid $2,000 for lodging, $400 for recreation, and $300 for life insurance premiums.

Even though your mother received a total of $2,700, she spent only $2,400 for her own support. Life insurance premiums are not support items. If you spent more than $2,400 for her support and no other support was received, you have provided more than half her support.

The total cost, not the period of time you provide the support, determines whether you provide more than half the support.

The year you provide the support is the year you pay for it, even if you do so with borrowed money that you repay in a later year.

If you use a fiscal year to report your income, you must provide more than half the dependent's support for the calendar year in which your fiscal year begins.

Armed forces dependency allotments. Both the part of the allotment contributed by the government and the part withheld from your military pay are considered provided by you in figuring whether you provide more than half the support. If your allotment is used to support persons other than those you name, you may take the exemptions for them, if they otherwise qualify as dependents.

Example. You are in the armed forces. You authorize an allotment for your widowed mother which she uses for the support of herself and your sister. If it provides more than half of their support, you may take an exemption for each of them, even though you authorize the allotment only for your mother.

Tax-exempt military quarters allowances are treated the same way as dependency allotments in figuring support. Both the allotment of pay and the tax-exempt basic allowance for quarters are considered as provided by you for support.

Tax-exempt income. In figuring the total support of a person, you must include tax-exempt income, savings, and borrowed amounts used to support that person. Tax-exempt income includes certain social security benefits, welfare benefits, life insurance proceeds, armed forces family allotments, nontaxable pensions, and tax-exempt interest.

Example 1. You provide $2,000 for your mother's support during the year. She has taxable income of $600, social security benefit payments of $1,800, and tax-exempt interest of $200. She uses all these for her support. You may not claim your mother as a dependent because the $2,000 you provide is not more than half her total support of $4,600.

Example 2. Your daughter takes out a student loan of $2,500 and uses it to pay her college tuition. She is personally responsible for the loan. You provide $2,000 toward her total support. You may not claim your daughter as a dependent because you provide less than half her support.

Social security benefit payments. If a husband and wife each receive social security benefit payments that are paid by one check made out to both of them, half the total paid is considered to be for the support of each spouse, unless they can show otherwise.

If a child receives social security benefits and uses them toward his or her own support, the payments are considered provided by the child.

State benefit payments (welfare, food stamps, housing, etc.) based on need are considered as support provided by the state, unless it is shown otherwise. For example, AFDC (Aid to Families with Dependent Children) is not considered support provided by the parent. It is support provided by the state.

When a relative is in a home for the aged or other institution supported by a state, religious, fraternal, or charitable organization, you must compare the amount spent by the agency to support the relative with the amount you spent to determine if you provided more than half the support. If you make a lump-sum advance payment to a home for the aged to take care of your relative for life and the payment is based on that person's life expectancy, the amount of your support each year is the lump-sum payment divided by the relative's life expectancy. Your support also includes any other amounts that you provided during the year.

Total Support

To figure if you provided more than half the support of a person, you must first determine the total support provided for that person.

Total support includes amounts spent to provide food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities.

Generally, the amount of an item of support is the amount of the expense incurred in providing that item. Expenses that are not directly related to any one member of a household, such as the cost of food for the household, must be divided among members of the household. If the item is property or lodging, the amount of such item is its fair rental value.

Example. Your parents live with you, your spouse, and your two children in a house you rent. The fair rental value of their share of lodging is $2,000 a year. Your father receives a nontaxable pension of $4,200, which he spends equally for items of support such as clothing, transportation, and recreation, for your mother and himself. Your total food expense for the household is $6,000. Your heat and utility bills amount to $1,200. Your mother has hospital and medical expenses of $600, which you pay during the year. Figure your parents' total support as follows:

	Support provided	
	Father	Mother
Fair rental value of lodging	$1,000	$1,000
Pension spent for their support	2,100	2,100
Share of food (1/6 of $6,000)	1,000	1,000
Medical expenses for mother		600
Parents' total support	$4,100	$4,700

Since you provided different amounts to each parent, you must figure the dependency status of each parent separately. You provide $2,000 ($1,000 lodging + $1,000 food) of your father's total support of $4,100—less than half. You provide $2,600 to your mother ($1,000 lodging, $1,000 food, $600 medical)—more than half of her total support of $4,700. You may claim your mother as a dependent, but not your father. Heat and utilities are included in the fair rental value of the lodging, and are not considered separately.

Lodging is the fair rental value of the room, apartment, or house in which the person lives. It includes a reasonable allowance for the use of furniture and appliances, and for heat and other utilities. Fair rental value is used in place of rent or taxes, interest, depreciation, paint, insurance, utilities, cost of furniture and appliances, etc. In some cases, fair rental value may be equal to the rent paid.

The fair rental value is the amount you could reasonably expect to receive from a stranger for the same kind of lodging.

If you are considered to provide the total lodging, determine the fair rental value of the room the person uses, or a share of the fair rental value of the entire dwelling if the person has use of your entire home.

If you do not provide the total lodging, the total fair rental value must be divided depending on how much of the total lodging you provide. If you provide only a part and the person supplies the rest, the fair rental value must be divided between you according to the amount each of you provides.

Example. Your parents live rent-free in a house you own. It has a fair rental value of $5,400 a year furnished, which includes a fair rental value of $3,600 for the house and $1,800 for the furniture. This does not include heat and utilities. The house is completely furnished with furniture belonging to your parents. You pay $600 for their utility bills. Utilities are not usually included in rent for houses in the area where your parents live. Therefore, you consider the total fair rental value of the lodging to be $6,000 ($3,600 fair rental value of the unfurnished house, $600 cost of utilities, and $1,800 allowance for furnishings provided by your parents) of which you are considered to provide $4,200 ($3,600 + $600).

Person living in his or her own home. The total fair rental value of a person's home is considered support contributed by that person.

If you help to keep up the home by paying interest on the mortgage, real estate taxes, fire insurance premiums, ordinary repairs, or other items directly related to the home or give someone cash to pay those expenses, reduce the total fair rental value of the home by those amounts in figuring that person's own contribution.

Example. You provide $3,000 cash for your father's support during the year. He lives in his own home, which has a fair rental value of $3,600 a year. He uses $800 of the money you give him to help pay his real estate taxes. Your father's contribution for his own lodging is $2,800 ($3,600 minus $800 for taxes).

If you live with a person rent-free in his or her home, you must reduce the amount you provide for support by the fair rental value of lodging he or she provides you.

Property provided as support is measured by its fair market value.

Capital expenses. Capital items, such as furniture, appliances, and cars, that are bought for a person during the year may be included in total support under certain circumstances.

The following examples show when a capital item is or is not support.

Example 1. You buy a $200 power lawn mower for your 13-year-old child. The child is given the duty of keeping the lawn trimmed. Because a lawn mower is ordinarily an item that benefits all members of the household, you cannot include the cost of the lawn mower in the support of your child.

Example 2. You buy a $150 television set as a birthday present for your 12-year-old child. The television set is placed in your child's bedroom. You include the cost of the television set in the support of your child.

Example 3. You pay $5,000 for a car and register it in your name. You and your 17-year-old child use the car equally. Because you own the car and do not give it to your child but merely let your child use it, you cannot include the cost of the car in your child's total support. However, you can include in your child's support your out-of-pocket expenses of operating the car for the benefit of your child.

Example 4. Your 17-year-old child, using personal funds, buys a car for $4,500. You provide all the rest of your child's support —$4,000. Since the car is bought and owned by your child, the car's fair market value ($4,500) must be included in your child's support. The $4,000 support you provide is less than half your child's total support of $8,500. You cannot claim your child as a dependent.

Medical insurance premiums include premiums you pay for supplementary medicare coverage. These are included in the total support you provide.

Medical insurance benefits, including basic and supplementary medicare benefits, are not part of support.

Amounts veterans receive under the GI Bill for tuition payments and allowances while they attend school are included in total support.

Example. During the year your son receives $2,200 from the government under the GI Bill. He uses this amount for his education. You provide the rest of his support —$2,000. Because GI benefits are included in total support, your son is not your dependent.

Other items may be considered as support depending on the facts in each case. For example, if you pay someone to provide child or disabled dependent care, you may include these payments as support, even if you claim a credit for them. For information on the credit, see Chapter 33.

Do Not Include in Total Support

The following items are not included in total support—

Federal, state, and local income taxes paid by persons from their own income.

Social security taxes paid by persons from their own income.

Life insurance premiums.

Funeral expenses.

Expenses you incurred for an induced abortion do not qualify as items of support for a child born alive during the tax year.

Scholarships received by your child if your child is a full-time student.

If a child is committed to a state training school because of antisocial behavior, the value of the room, board, and education provided is not a scholarship. It must be included in support.

Survivors' and Dependents' Educational Assistance payments used for support of the child who receives them.

Phaseout of Exemptions

Beginning in 1988, the amount you can claim as a deduction for exemptions is phased out once your taxable income goes above a certain level for your filing status. These levels are as follows:

Filing Status	Taxable Income Subject to Exemption Phaseout
Single	$ 89,560
Married filing jointly	149,250
Married filing separately	113,300
Head of household	123,790
Qualifying widow(er)	149,250

If your taxable income is more than the amount shown in the above table, you continue to deduct your exemptions on Form 1040 (taxpayers with taxable income over $50,000 must use Form 1040) as usual. You compute the exemption phaseout when you figure your tax using the *Tax Rate Schedules*.

Caution: As this publication was being prepared for print, Congress was considering legislation that would prevent married taxpayers from avoiding the full effect of the phaseout of exemptions by filing separate returns.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

You may use the following worksheet to figure your tax for 1988.

Exemption Phaseout Worksheet

1. If your filing status is:
   - Single, enter $25,076.80
   - Head of household, enter $34,661.20
   - Married filing jointly or Qualifying widow(er), enter $41,790.00
   - Married filing separately, enter $33,657.75 ____________
2. Enter your taxable income (1988 Form 1040, line 37): ____________
3. Enter the amount shown below for your filing status:
   - Single, enter $89,560
   - Head of household, enter $123,790
   - Married filing jointly or Qualifying widow(er), enter $149,250
   - Married filing separately, enter $113,300 ____________
4. Subtract line 3 from line 2. Enter the result. (The result should be over zero. If it is not, use the Tax Rate Schedules to figure your tax.) ____________
5. Multiply the amount on line 4 by **28% (.28)**. Enter the result. ____________
6. Multiply the amount on line 4 by **5% (.05)**. Enter the result. ____________
7. Multiply **$546** by the number of exemptions you claim on your return. (If you are married filing separately, see ***Caution*** below.) Enter the result. ____________
8. Compare the amounts on lines 6 and 7. Enter the smaller of the two amounts. ____________
9. Tax: add lines 1, 5, and 8. This is your tax. ____________

Caution: Pending legislation would require married persons filing separately who did not claim an exemption for their spouse to add $546 to the result otherwise figured on line 7 above. See Publication 553, *Highlights of 1988 Tax Changes*, to find out whether this law was passed.

Example. Janet files as head of household and claims three exemptions. She has taxable income of $145,590. Because Janet's taxable income is more than the amount shown for her filing status ($123,790), she must figure her tax by phasing out her exemptions. The worksheet below shows how she arrives at her tax of $41,855. She enters this amount on her tax return.

Exemption Phaseout Worksheet

1. If your filing status is:
   - Single, enter $25,076.80
   - Head of household, enter $34,661.20
   - Married filing jointly or Qualifying widow(er), enter $41,790.00
   - Married filing separately, enter $33,657.75 $ 34,661
2. Enter your taxable income (1988 Form 1040, line 37): 145,590
3. Enter the amount shown below for your filing status:
   - Single, enter $89,560
   - Head of household, enter $123,790
   - Married filing jointly or Qualifying widow(er), enter $149,250
   - Married filing separately, enter $113,300 123,790
4. Subtract line 3 from line 2. Enter the result. (The result should be over zero. If it is not, use the Tax Rate Schedules to figure your tax.) 21,800
5. Multiply the amount on line 4 by **28% (.28)**. Enter the result. 6,104
6. Multiply the amount on line 4 by **5% (.05)**. Enter the result. 1,090
7. Multiply **$546** by the number of exemptions you claim on your return. (If you are married filing separately, see ***Caution*** below.) Enter the result. 1,638
8. Compare the amounts on lines 6 and 7. Enter the smaller of the two amounts. 1,090
9. Tax: add lines 1, 5, and 8. This is your tax. $ 41,855

Caution: Pending legislation would require married persons filing separately who did not claim an exemption for their spouse to add $546 to the result otherwise figured on line 7 above. See Publication 553, *Highlights of 1988 Tax Changes*, to find out whether this law was passed.

Social Security Number for Dependent

If you claim a dependent who is at least 5 years old by the end of a tax year (***age 2 or older for returns due after 1989***) and is a U.S. citizen or resident, or a resident of Canada or Mexico, you must list the dependent's social security number (SSN) on your Form 1040 or Form 1040A. If you do not list the dependent's SSN when required or if you list an incorrect SSN, you may be subject to a $5 penalty.

If a person who you expect to claim as a dependent on your return does not have an SSN, either you or that person should apply for an SSN as soon as possible. The Internal Revenue Service does not issue social security numbers. Apply for an SSN by filing Form SS–5 with the Social Security Administration. You can obtain Form SS–5 from the Social Security Administration. Information about applying for an SSN is available at your local Social Security Administration office.

Multiple Support Agreement

Sometimes no one provides more than half the support of a person. Instead, two or more persons, each of whom would be able to take the exemption but for the support test, together provide more than half the person's support.

When this happens, you may agree that any one of you who individually provides more than 10% of the person's support, ***but only one,*** may claim an exemption for that person. Each of the others must sign a written statement agreeing not to claim the exemption for that year. The statements must be filed with the income tax return of the person who claims the exemption. Form 2120, *Multiple Support Declaration,* is used for this purpose.

Example 1. You, your sister, and your two brothers provide the entire support of your mother for the year. You provide 45%, your sister 35%, and your two brothers each provide 10%. Either you or your sister may claim an exemption for your mother. The other must sign a Form 2120 or a written statement agreeing not to claim an exemption for her. Because neither brother provides more than 10% of the support, neither of them can claim the exemption. They do not have to sign a Form 2120 or the statement.

Example 2. You and your brother each provide 20% of your mother's support for the year. The remaining 60% of her support is provided equally by two persons who are not related to her. She does not live with them. Because more than half her support is provided by persons who cannot claim her as a dependent, no one may claim the exemption.

Example 3. Your father lives with you and receives 25% of his support from social security, 40% from you, 24% from his brother, and 11% from a friend. Either you or your uncle may claim the exemption for your father. A Form 2120 or a written statement from the person not claiming the exemption must be attached to the return of the person who claims the exemption.

Support Test for Divorced or Separated Parents

The support test for a child of divorced or separated parents is based on special rules that apply only if:

1) The parents are divorced, legally separated under a decree of divorce or separate maintenance, are separated under a written separation agreement, or lived apart at all times during the last 6 months of the calendar year, and
2) One or both parents provide more than half the child's total support for the calendar year, and
3) One or both parents have custody of the child for more than half the calendar year.

Child is defined earlier under the *Gross Income Test.*

Exceptions. This discussion does not apply in any of the following situations:

1) A third party, such as a relative or friend, provides half or more of the child's support,
2) The child is in the custody of a person other than the parents for half the year or more,
3) The support of the child is determined under a multiple support agreement, as discussed earlier,
4) The parents are separated under a written separation agreement, or are living apart, but they file a joint return for the tax year, or
5) The child is not the child of the divorced or separated parents. Support of other persons is determined under the regular method discussed previously under *Support Test.*

Custodial parent. The parent who has custody of the child for the greater part of the year is generally treated as the parent who provides more than half the child's support. It does not matter whether that parent actually provided more than half the support. However, see *Noncustodial parent,* later.

Custody is usually determined by the terms of the most recent decree of divorce or separate maintenance, or a later custody decree. If there is no decree, use the written separation agreement. If neither a decree nor agreement establishes custody, then the parent who has the physical custody of the child for the greater part of the year is considered to have custody of the child. This also applies if the validity of a decree or agreement awarding custody is uncertain because of legal proceedings pending on the last day of the calendar year.

If the parents are divorced or separated during the year and had joint custody of the child before the separation, the parent who has custody for the greater part of the rest of the year is considered to have custody of the child for the tax year.

Example 1. Under the terms of your divorce, you have custody of your child for 10 months of the year. Your former spouse has custody for the other 2 months. You and your former spouse provide the child's total support. You are considered to have provided more than half the support of the child. However, see *Noncustodial parent.*

Example 2. Assume that in Example 1 your aunt gives $2,000 of the $3,100 necessary to support your child. Neither you nor your former spouse may take the child as a dependent, because the two of you did not provide more than half the child's support.

Noncustodial parent. The noncustodial parent will be treated as providing more than half of the child's support if:

1) The custodial parent signs a written declaration that he or she will not claim the exemption for the child, and the noncustodial parent attaches this written declaration to his or her return, or

2) A decree or agreement executed before 1985 provides that the noncustodial parent is entitled to the exemption and he or she provides at least $600 for the child's support during the year, unless the pre-1985 decree or agreement is modified after 1984 to specify that this provision will not apply.

If a pre-1985 written agreement between the parents gives the exemption to the parent who does not have custody, check the box for pre-1985 agreements on that person's return (line 6(d) of Form 1040A and Form 1040).

Example. Under the terms of your 1982 divorce decree, your former spouse has custody of your child. The decree specifically states that you are entitled to the exemption. You provide at least $600 in child support during the calendar year. You are considered to have provided more than half the child's support.

Written declaration. The custodial parent should use Form 8332, ***Release of Claim to Exemption for Child of Divorced or Separated Parents,*** or a similar statement, to make the written declaration to release the exemption to the noncustodial parent. The noncustodial parent must attach the form or statement to his or her tax return.

The exemption may be released for a single year, for a number of specified years (for example, alternate years), or for all future years, as specified in the declaration. If the exemption is released for more than one year, the original release must be attached to the return of the noncustodial parent for the first year of such release, and a copy of the release must be attached to the return for each succeeding taxable year for which the noncustodial parent claims the exemption.

Note. Since Form 8332 is presently irrevocable, the custodial parent who signs the release should make sure it is completed accurately.

Child support. All child support payments actually received from the noncustodial parent are considered used for the support of the child.

Example. The noncustodial parent provides $1,200 for the child's support. This amount is considered as support provided by the noncustodial parent even if the $1,200 was actually spent on things other than support.

Support payments for an earlier year. If support payments made this year are not more than the amount required of the noncustodial parent, the amount of support provided by that parent is not reduced by any payment of support that parent owed for an earlier year. If the support payments are more than the amount required for this year, any payment for an earlier year is not support provided by the noncustodial parent for either the earlier year or for this year. It is reimbursement to the custodial parent for amounts paid for the support of the children in an earlier year.

Example. Under your divorce decree, you must pay $400 a month to your former spouse for the support of your two children. Last year you paid $4,000 instead of $4,800 due for the year. This year, if you pay the full amount, the entire $4,800 is considered support that you provided. If you also pay any part of the $800 you owe from last year, that amount is not included as support provided by you in either year.

Support provided by a third party for a divorced or separated parent is not included as support provided by that parent.

Example. You are divorced. During the whole year, you and your child live with your mother in a house she owns. The fair rental value of the lodging provided by your mother for your child is $1,000. The home provided by your mother is not included in the amount of support you provide.

Remarried parent. If you remarry, the support provided by your new spouse is treated as provided by you.

Example. You have two children from a former marriage who live with you. You have remarried and are living in a home owned by your present spouse. The fair rental value of the home provided to the children by your present spouse is treated as provided by you.

Home jointly owned. If you and your former spouse each has the right to use and live in the home, each of you is considered to provide half of your child's lodging. However, if the divorce decree gives only you the right to use and live in the home, you are considered to provide your child's entire lodging. It does not matter if the legal title to the home remains in the names of both parents.

Medical expenses. A child of divorced or separated parents or of parents who live apart during the last 6 months of the year is treated as a dependent of both parents for the medical expense deduction if the child receives more than half of his or her support from the parents. Thus, a parent can deduct medical expenses he or she paid for the child even though the other parent claims an exemption for the child. This special rule does not apply if more than half of the child's support is treated as received from a person under a multiple support agreement.

4. Decedents

A final return must be filed on Form 1040, Form 1040A, or Form 1040EZ for a decedent (person who died), if the filing requirements discussed in Chapter 1 apply.

If the person who died did not meet any of the requirements for filing a return, but had tax withheld or paid estimated tax, a return should be filed to get a refund of the tax paid or withheld. A return should also be filed if the decedent was entitled to a refundable credit, such as the earned income credit.

If a refund is due, to claim it you must file Form 1310, *Statement of Person Claiming Refund Due a Deceased Taxpayer,* and attach it to the decedent's return. However, if you are a surviving spouse filing a joint return, or a personal representative filing Form 1040, Form 1040A, or Form 1040EZ for the decedent, you do not have to file Form 1310.

For more information on income tax returns of the decedent and the decedent's estate, see Publication 559, *Tax Information for Survivors, Executors, and Administrators.*

The Final Return

The executor, administrator (person with legal responsibility to take care of the decedent's affairs), or survivor must file the final return and any other return still due for the decedent. If you are acting in any fiduciary capacity (such as an executor or administrator), you must file a written notice with the Internal Revenue Service. Form 56, *Notice Concerning Fiduciary Relationship,* is available for this purpose. For more information, see Publication 559.

The date of death should be shown with the decedent's name in the name and address space on the return. The person who files the return should write "deceased" after the decedent's name. If a joint return is not being filed, the personal representative's name and address should be shown in the remaining space. Also write "DECEASED" across the top of the tax return. Include the same information on any Form 1040X, *Amended U.S. Individual Income Tax Return,* that is filed for a decedent.

A joint return for you and your deceased spouse generally should be filed by you and the executor or administrator. But you may file the joint return if there is no executor or administrator appointed before the due date for filing.

This also applies if your spouse died after the end of the tax year but before filing the return.

A joint return should show your spouse's 1988 income before death and your income for all of 1988.

If you remarried before the end of the year in which your spouse died, you may not file a joint return with your deceased spouse. The filing status of the decedent is married filing separately.

Change to separate return. An executor may change the joint return to a separate return. An executor or administrator appointed after a surviving spouse has filed a joint return with the decedent may cancel that return by filing a separate return for the decedent within one year from the due date of the return. The joint return will then become the survivor's separate return and the tax will be refigured on the separate return.

When to file. The final return is due by the date the decedent's return would have been due had death not occurred.

For a calendar year taxpayer, the final return generally is due by April 15 of the year following death, regardless of when during the year death occurred.

Death after a tax year. If the decedent died after the end of a tax year but before filing a return, a return must be filed for that year. A final return must then be filed for the year of death.

A request for prompt assessment of tax can shorten the time the Internal Revenue Service has in which to tax the estate of the decedent. A request may be filed by the executor, administrator, or other representative of the decedent's estate after filing the decedent's final return or the estate's income tax return. The Internal Revenue Service usually has 3 years after the filing of a return or its due date, whichever is later, to charge any more tax that may be due from the decedent. The request reduces the time for charging the tax to 18 months from the date the written request for prompt assessment was received. This may permit a quicker settlement of the tax responsibility of the estate and earlier distribution of the decedent's assets, such as money and property, to the beneficiaries.

Form 4810, *Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)*, may be used for making this request. The request must be filed separately from any other document. Send the request to the Internal Revenue Service office where the final return or the estate's income tax return was filed. The request must be made within 3 years after the return was filed. If Form 4810 is not used, you must clearly indicate that it is a request for prompt assessment under Section 6501(d) of the Internal Revenue Code.

Signing the return. If an executor or administrator has been appointed, he or she must sign the return that is filed for the decedent. If a joint return is filed, the surviving spouse also must sign. If no executor or administrator has been appointed and a joint return is filed, the surviving spouse should sign the return and write in the signature area "Filing as surviving spouse." If no executor or administrator has been appointed and if there is no surviving spouse, the personal representative must file and sign the return as "personal representative."

Where to file. You may mail the decedent's final income tax return to the Internal Revenue Service Center for the place where you live. Hand carried returns, however, may be filed with any office of the district director within your district.

Income Included in Final Return

If the decedent used the cash method of accounting, which most people use, the final return should show only the items of income, including self-employment income, that the decedent actually or constructively received before death.

If the decedent used the accrual method, the final return should show only those items of income, including self-employment income, that the decedent accrued before death. See Chapter 1 for discussion of accounting methods and constructive receipt.

Interest and dividend income (Forms 1099). Payers of interest, dividends, and certain other income report amounts on Forms 1099 using the identification number of the person to whom the account is payable. After a decedent's death, the Forms 1099 must reflect the identification number of the person to whom the amounts are payable. The executor must furnish this identification number to the payer. For example, if income, such as interest, is payable to the estate, the estate's identification number must be provided to the payer and used to report the interest on Form 1099–INT, *Statement for Recipients of Interest Income*. If the interest is payable to a surviving joint owner, the survivor's identification number must be provided to the payer and used to report the interest.

A Form 1099 should be received for the decedent reporting amounts earned prior to death. A separate Form 1099 should be received showing the amounts earned after the date of death and payable to the estate or other recipient. You may request corrected Forms 1099, if these forms do not properly reflect the right recipient or amounts.

The amount reported on a Form 1099 may not necessarily be the amount that should be properly reported on each income tax return. For example, a Form 1099–INT reporting interest payable to a decedent may include income that is properly reportable on the final income tax return of the decedent, as well as income earned after the date of death that is reportable by the estate or other recipient. You should ask the payer for a Form 1099 that properly identifies the recipient (by name and identification number) and the proper amounts. If that is not possible, include an explanation with the return, such as that described below under *How to report*, showing the amounts that are to be properly reported on the decedent's final return.

How to report. If you have received Forms 1099–INT or Forms 1099–DIV for the decedent that include amounts received as a nominee for another recipient (the decedent's estate or another beneficiary), prepare the decedent's final return as follows.

1) Report the total interest amounts, including that shown on Forms 1099–INT, on line 2, Part I of Schedule B (Form 1040).
2) Report the total dividend income, including that shown on Forms 1099–DIV, on line 4, Part II of Schedule B (Form 1040).
3) On the appropriate schedule part, enter a "subtotal" of the combined amounts of all of the interest or dividends reflected on Forms 1099, along with the interest or dividends from all other sources.
4) Below this subtotal, write "Nominee Distribution" and show the amount of any interest or dividends received that belongs to another recipient. Subtract it from the subtotal.
5) Report the net result on the proper line of the part of the income schedules being used, and follow the directions shown for that line to carry the amount forward to the front of the return.

See Chapters 8 and 9 for more information about interest and dividend income, including certain actions a nominee must take.

Partnership income. If the decedent was a partner, the final return must include the decedent's distributive share of partnership income for the partnership's tax year that ends within or with the decedent's last tax year. If the partnership year is terminated with the death of a partner, see Publication 541, *Tax Information on Partnerships*.

The decedent's distributive share of partnership income for a partnership tax year ending after the decedent's death is not included in the final return. In this case, partnership income earned up to and including the date of death is *Income in Respect of the Decedent*, discussed later in this chapter.

For information on how to compute the deceased partner's self-employment income, see Publication 541.

S corporation income. If the decedent was a shareholder in an S corporation, the decedent's share of the S corporation income is treated as discussed under *Partnership income*, earlier.

Other income. The rules on income discussed in the other chapters of this publication also apply to a decedent's final return.

Deductions, Credits, Exemptions

If the decedent was married at the time of death, separate returns are filed, and itemized deductions are elected by (or for) one spouse, the other spouse cannot take the standard deduction and should also itemize deductions. Otherwise, the standard deduction can be used to figure taxable income on the decedent's final return. However, if the total of the decedent's itemized deductions are more than the decedent's standard deduction, the Federal income tax will generally be less if itemized deductions are used. See Chapter 22.

Itemized deductions. If the decedent used the cash method of accounting, include only the expenses that the decedent paid before death. If the decedent used the accrual method, include only those expenses that the decedent accrued before death.

However, medical expenses paid for the care of the decedent may be treated as paid by the decedent at the time they were incurred, even if they are paid after death. See Chapter 23.

All deductions and credits discussed in this publication apply to the final return, if the decedent was eligible for the deduction or credit at the time of death.

Income tax withheld from the decedent's pay, pensions, or annuities before death, and any estimated income tax that was paid, must be claimed on the decedent's final return.

Standard deduction. The amount of the standard deduction for a decedent's final tax return is the same as it would have been had the deceased continued to live. A higher standard deduction is allowed if, at the time of death, the decedent was blind or age 65 or over. However, if the decedent can be claimed as a dependent of another taxpayer, the amount of the standard deduction may be limited. See Chapter 22 for more information about determining the amount of the standard deduction.

Personal exemption. The personal exemption amount is allowed in full on a decedent's final tax return, unless the decedent can be claimed as a dependent on another taxpayer's return. See Chapter 3.

Survivors

Survivors may be entitled to certain benefits when filing their own income tax returns.

A surviving spouse may file a joint return with the deceased spouse for the year of death if the survivor does not remarry before the end of that year. If there is a dependent child, the survivor may be entitled to use the standard deduction amount and the tax rates that apply to married individuals filing joint returns for the 2 following years. See *Qualifying Widows and Widowers* in Chapter 2.

If the decedent qualified as your dependent for the part of the year before death, you may claim the full exemption for such dependent on your tax return, regardless of when death occurred during the year. However, if you can claim the decedent as a dependent on your return, and a final return for the decedent is required to be filed, the amount of the personal exemption that can be claimed on the decedent's final return is zero and the amount of the standard deduction may be limited. See Chapters 3 and 22.

Income in Respect of the Decedent

All gross income that the decedent had a right to receive, that is not includible in the final return, is income in respect of the decedent. Do not report this income on the final return of the decedent, but include it, for the tax year when received, in the gross income of:

1) The decedent's estate, if the estate acquired the right to receive the amount from the decedent, or
2) The person to whom the right to the income passed directly if the estate did not receive that right from the decedent, or
3) Any person to whom the estate properly distributes the right to receive the amount.

Example 1. Joe Jones owned and operated an orchard. He used the cash method of accounting. He sold and delivered $2,000 worth of fruit to a customer, but did not receive payment before his death. When the estate was settled, payment had not been made, and the estate gave the right to receive the payment to his niece as beneficiary. When she collects the $2,000, she must include it in her return.

Example 2. If, in Example 1, Joe Jones had used the accrual method of accounting, the income from the fruit sale must be included on his final return. His niece does not include the income in her return, even if the money is later paid to her as his beneficiary.

Example 3. Mary Smith was entitled to a large salary payment at the date of her death. It was to be paid in five yearly payments. Her estate, after collecting two payments, gives the right to the remaining payments to you, the beneficiary. None of the payments would be included in the decedent's final return. The estate must include in its gross income, as income in respect of the decedent, the two payments it received. You must include in your gross income each of the three remaining payments as you receive them.

If you transfer your right to income in respect of a decedent, you must include in your income whichever amount is larger:

1) The amount you receive for the right, or
2) The fair market value of the right you transfer. Fair market value is defined in Chapter 15.

If you make a gift of such a right, you must include in your gross income the fair market value of the right at the time you make the gift.

The character (type) of the income you receive in respect of a decedent is the same as it would have been had the deceased continued to live. For example, if the income would have been a capital gain to the decedent, it will be a capital gain to you.

Interest on savings certificates that applies to the period from the date of the last payment to the date of death, but not received as of that date, is interest income in respect of a decedent. Interest attributable to a period after the decedent's death that becomes payable on the certificates after death is not income in respect of a decedent. Such interest, however, is ordinary income includible in the gross income of the respective recipients.

If you collect on an installment obligation (such as a mortgage or a note) you received from a decedent, you use the same gross profit percentage the decedent would have used to arrive at the part of each payment collected that represents profit. See Publication 537, *Installment Sales.*

If you sell or exchange an installment obligation you received from a decedent, the rules for disposition of installment obligations apply. See Publication 537. However, your basis for the obligation is the same as the decedent's basis, adjusted for all installment payments you received before the sale or exchange.

Expenses in Respect of the Decedent

Expenses in respect of the decedent are items such as business expenses, income-producing expenses, interest, and taxes, for which the decedent was liable, but which are not deductible on the decedent's final income tax return. These expenses will be allowed as a deduction to the estate of the decedent in the tax year paid. If the estate is not liable for them, they are deductible by the person who receives an interest in the decedent's property subject to these expenses.

Deduction of federal estate tax. If you include income in respect of a decedent in your gross income for any tax year, you may take as a deduction for that same year a part of the federal estate tax on the decedent's estate.

If the income is ordinary income, you may claim the deduction only as a miscellaneous itemized deduction on Schedule A (Form 1040). This deduction is not subject to the 2% limit on miscellaneous itemized deductions, discussed in Chapter 30.

If the income is capital gain income, then in figuring the maximum capital gain rate or any net capital loss limitation, the amount of the gain must be reduced, but not below zero, by the amount of any estate tax deduction attributable to such gain.

For more information on the income tax deduction for estate tax paid on income in respect of a decedent, see Publication 559.

5. Tax Withholding and Estimated Tax

The federal income tax is a pay-as-you-go tax. You must pay the tax as you earn or receive income during the year. There are two ways to pay as you go:

- ***Withholding.*** If you are an employee, your employer will withhold income tax from your pay. Tax is also withheld from other types of income—including pensions, bonuses, commissions, and gambling winnings. In each case, the amount withheld is paid to the Internal Revenue Service in your name.
- ***Estimated tax.*** If you do not pay your tax through withholding, or do not pay enough tax that way, you might have to pay estimated tax. People who are in business for themselves generally will have to pay their tax this way. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax as well.

This chapter explains income tax withholding and the penalty for not paying enough tax during the year. It also explains how to take credit on your 1988 return for your tax withholding and estimated tax payments. Estimated taxes are fully explained in Publication 505, *Tax Withholding and Estimated Tax.*

New tax law. Some of the tax law changes that you should consider when you figure your income tax withholding or estimated tax for 1989 are discussed in this section. For information on other changes in the tax law, see Publication 533, *Highlights of 1988 Tax Changes.*

Personal exemption. For 1989, the personal exemption amount for you, your spouse, and each dependent has increased to $2,000.

Standard deduction. Individuals who do not itemize deductions have an increased standard deduction for 1989. The amount of your standard deduction will depend on your filing status, whether you or your spouse is age 65 or over or blind, and whether you can be claimed as a dependent on another person's return. See Publication 505 or the instructions for Form 1040–ES.

Personal interest. For 1989, only 20% of personal interest (such as interest on car loans or credit card balances for personal expenses) is deductible as an itemized deduction. See Chapter 25.

Dependent care assistance programs. If your employer provides you with child or disabled dependent care services to allow you to work, the amount your employer pays for the services (within certain limits) is excluded from your income. Beginning in 1989, the exclusion will be allowed only if you include on your tax return the name, address, and taxpayer identification number (usually the social security number) of the care provider.

Child and dependent care credit. Beginning in 1989, the credit for child and dependent care expenses has several new rules:

- The child being cared for must be under age 13 (age 15 in 1988),
- Work-related expenses eligible for the credit ($2,400 for one qualifying person and $4,800 for two or more qualifying persons) must be reduced by any reimbursement you receive under an employer's dependent care assistance program and exclude from your income, and
- You must include on your tax return the name, address, and taxpayer identification number (usually the social security number) of the care provider.

Employee business expenses. Unreimbursed employee business expenses can be claimed on Schedule A (Form 1040) as a miscellaneous itemized deduction subject to the 2% of adjusted gross income limit. Beginning in 1989, this treatment also applies to amounts you receive under your employer's reimbursement arrangement if the arrangement:

- Does not require you to adequately account to your employer for your expenses or
- Allows you to keep any excess reimbursement or allowance over the expenses adequately accounted for.

The reimbursement under such an arrangement is subject to income tax withholding.

Supplemental Medicare premium. Beginning in 1989, you may owe a supplemental Medicare premium if you are eligible for Medicare Part A (hospital insurance) benefits for more than 6 full months and your 1989 income tax is $150 or more. The supplemental premium will be used to help pay the cost of the new Medicare coverage for catastrophic expenses and prescription drugs.

You must add the premium to the tax shown on your 1989 income tax return. You should increase your income tax withholding or estimated tax payments for 1989 to cover the amount of your supplemental Medicare premium. For 1989 only, you will not owe a penalty for any underpayment of estimated tax due to the supplemental premium. Beginning in 1990, however, the supplemental premium will be subject to the penalty for underpayment of estimated tax.

The 1989 premium is based on a rate of $22.50 for each $150 of your income tax (with certain adjustments), up to a maximum premium of $800. However, if you are married and both you and your spouse are eligible for Medicare Part A, the maximum premium is $1,600 unless you do not live with your spouse at any time in 1989 and file a separate return.

If you are married and file a joint return, and only one spouse is eligible for Medicare Part A, your premium is based on one-half of your joint income tax, even if all the income is earned by the other spouse.

For more information, see Publication 934, *Supplemental Medicare Premium*. You should use the worksheet in that publication to figure your 1989 adjusted income tax if you expect to pay additional taxes or claim credits against your tax. Publication 934 also contains a worksheet and table for figuring a special tax adjustment available to certain individuals who receive a taxable government pension.

Proposed tax law changes. As this publication was being prepared for print, Congress was considering legislation that could affect the amount of your tax for 1989. Following are some of the items that may be changed. For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Exemption phaseout. When you figure your tax, the amount you claim as a deduction for exemptions is phased out once your taxable income goes above a certain level for your filing status. The proposed legislation would require use of a computation that would prevent married taxpayers from avoiding the full effect of the phaseout by filing separate returns.

Educational assistance programs. Before 1988, up to $5,250 of educational assistance provided by your employer under a qualified written plan could be excluded from your income. The proposed legislation would extend the educational assistance exclusion through 1990. After 1988 the exclusion would be limited to $1,500.

Moving expenses. Unless you are reimbursed by your employer, you may deduct only 80% of the amount you spend for meals that are deductible as a moving expense. The proposed legislation would limit your deduction for such meals to 80% of their cost even if you are reimbursed.

Military fringe benefits. Most U.S. military fringe benefits are not taxable. Under the proposed legislation, the value of personal use of military vehicles would be subject to tax.

Amortizable bond premium. The proposed legislation would treat amortizable bond premium on any bond acquired after 1987 as an offset to interest income on the bond, rather than as a separate deduction subject to the investment interest limitations. This treatment would be elective for bonds acquired after October 22, 1986, and before 1988.

Capital loss limit. If you have a net capital loss, your deduction for the tax year is limited to the amount of the loss or $3,000 ($1,500 if you are married and file a separate return), whichever is smaller. Under the proposed legislation, your capital loss deduction would be further limited to the amount of your taxable income.

Health insurance for self-employed. If you are self-employed, you generally can deduct 25% of your health insurance premiums as an adjustment to income. This deduction cannot be more than your earned income from self-employment. Under the proposed legislation, the deduction would be limited to your earned income from the trade or business in which the health insurance plan is established.

Charitable contribution deduction. You may deduct contributions to charitable organizations only to the extent their value is more than the value of any benefits you receive. Under the proposed legislation, an 80% charitable contribution deduction would be allowed for payments to an institution of higher education if you thereby receive the right to purchase seating in an athletic stadium of the institution.

Mutual fund expenses. If you are a shareholder in a mutual fund, the expenses of the fund are passed through to you and included in your income. You can deduct the expenses on your return as a miscellaneous itemized deduction subject to the 2% of adjusted gross income limit. For 1987 this rule did not apply to publicly offered mutual funds. The proposed legislation would extend the exemption for publicly offered mutual funds to tax years beginning after 1987.

Alternative minimum tax. The proposed legislation would make several changes in the rules for figuring alternative minimum tax, including the following:

- ***If you are married and file a separate return***, your alternative minimum tax would be increased by the ***lesser*** of (1) 25% of the amount by which alternative minimum taxable income (figured without this increase) exceeds $155,000 or (2) $20,000.
- ***Personal exemptions*** would not be allowed for minimum tax purposes.
- ***A child under age 14*** who has more than $1,000 of investment income will have alternative minimum tax of not less than the amount of increase in the parent's alternative minimum tax that would be caused by including the child's net unearned minimum taxable income in the parent's alternative minimum taxable income.

Withholding

Income tax is generally withheld from the following kinds of income:

Salaries and wages. Income tax is withheld from the pay of most employees. This includes bonuses, commissions, and vacation allowances, in addition to your regular pay. Military retirement pay is treated in the same manner as wages for income tax withholding purposes, even though it is treated as a pension or annuity for other tax purposes. If you are a farmworker or a household worker, you can ask your employer to withhold income tax from your pay. Tax will be withheld only if you want it withheld and your employer agrees to withhold it.

Tips. The tips you receive and report to your employer while working as an employee are counted in with your regular wages to figure the amount that is withheld.

Taxable fringe benefits. Your employer can withhold income tax at a flat rate of 20% (or at your regular rate of withholding) on taxable fringe benefits paid to you.

Sick pay. Income tax is withheld from sick pay you receive from your employer or an agent of your employer, just as it is from your salaries and wages. If you receive sick pay from someone who is not acting as an agent of your employer, such as an insurance company, you can usually arrange to have income tax withheld from the sick pay. A special rule covers sick pay paid to you under certain union agreements.

Pensions and annuities. Income tax will be withheld from your pension or annuity, unless you choose not to have it withheld.

Gambling winnings. Income tax at a flat rate of 20% is withheld from certain gambling winnings.

Withholding on Salaries and Wages

The amount of income tax withheld from your regular pay depends on two things:

- The amount you earn and
- The information you give your employer on Form W–4, *Employee's Withholding Allowance Certificate.*

Form W–4 includes three types of information that your employer will use to figure your withholding:

- Whether to withhold at the single rate or at the lower married rate.
- How many withholding allowances you claim. Each withholding allowance reduces the amount that will be withheld.
- Whether you want to have an additional amount withheld.

If your income is low enough that you will not have to pay income tax for the year, you may be exempt from withholding. See *Exemption from Withholding,* later.

When you start a new job, you must fill out Form W–4 and return it to your employer. Your employer should have copies of the form. If you later need to change the amount that is being withheld or the information you gave, you must fill out a new form.

If too much or too little tax is being withheld from your wages, you should file a 1989 Form W–4 to change the amount of your withholding. See *Getting the Right Amount of Tax Withheld,* later.

Supplemental Medicare premium. As explained earlier under *New tax law,* if you will owe a supplemental premium for 1989 you should increase your withholding or estimated tax payments to cover the amount you will owe. To increase your withholding, complete a 1989 Form W–4. Divide the amount of your supplemental premium by the number of paydays remaining in 1989 and enter the result on line 5 of the form. Be sure to enter on the new form the same number of allowances your employer now uses for your withholding. Give the completed form to your employer.

Completing Form W–4

The following discussions explain how to complete your Form W–4.

Marital status. The tax rates for married people filing a joint return are lower than those for single taxpayers. Therefore, there is a lower married withholding rate for people who can use the tax rates for joint returns. Everyone else must have tax withheld at the higher single rates.

You must claim ***single*** status if:

- **You are single.** If you are divorced, or separated from your spouse under a court decree of separate maintenance, you are considered single.
- **You are married, but you are neither a citizen nor a resident of the United States,** or your spouse is neither a citizen nor a resident of the United States. However, if one of you is a citizen or a resident, you can choose to have the other treated as a resident. You may then file a joint return and you will be able to claim married status on your Form W–4. See Publication 519, *U.S. Tax Guide for Aliens,* for more information.

You can claim ***married*** status if:

- **You are married and neither you nor your spouse is a nonresident alien.** You are considered married for the whole year even if your spouse died during the year.
- **You expect to be able to file your return as a qualifying widow or widower.** You can generally use this filing status if your spouse died within the previous two years and you have a child who is your dependent. See Chapter 2.

Some married people find that they do not have enough tax withheld at the married rates. This can happen, for example, when both spouses work. Therefore, even if you qualify for the married rates, you can still choose to have tax withheld at the higher single rates.

Withholding allowances. The more allowances you claim on Form W–4, the less income tax your employer will withhold. You will have the most tax withheld if you claim "0" allowances. The number of allowances you can claim depends on:

- How many exemptions you can take on your tax return,
- Whether you have income from more than one job,
- What deductions, adjustments to income, and credits you expect to have for the year, and
- Whether you will file as head of household.

If you are married, it also depends on whether your spouse also works and claims any allowances on his or her own Form W–4. If you both work, you may figure your combined allowances and divide them between you. See *Two jobs,* later.

Form W–4 worksheets. Form W–4 has worksheets to help you figure how many withholding allowances you can claim. The worksheets are for your own records. Do not submit them with the form. However, you are not required to use the worksheets if you use a more accurate method of withholding. See Publication 505 for more information on using an alternative method of figuring withholding allowances.

Withholding and estimated tax. If you will have to pay any estimated tax (discussed later) for the year, you must first use your estimated adjustments, deductions, and tax credits to reduce your estimated tax. In figuring the number of withholding allowances you can claim, you can take into account only the amount of these items remaining after you have reduced your estimated tax to zero.

Two jobs. If you have income from two jobs at the same time, or if you and your spouse are both wage earners and file a joint return, you must split your allowances between the Forms W–4 for each job. You cannot claim the same allowances with more than one employer at the same time. You can claim all of your allowances with one employer and none with the other, or divide them in any other way you wish. Do not complete more than one set of Form W–4 worksheets.

If both you and your spouse work and you expect to file a joint return, you should figure your withholding allowances using your combined income, adjustments, deductions, exemptions, and credits. You may divide your total allowances in any way you wish, but you may not claim an allowance that your spouse also claims.

If you and your spouse expect to file separate returns, you each must figure your allowances separately, based on your own individual income, adjustments, deductions, exemptions, and credits.

Personal Allowances Worksheet. Use the Personal Allowances Worksheet to figure your withholding allowances for exemptions. If they apply, add the special allowance for only one job, the allowance for head of household status, and the allowance for the child and dependent care credit.

Special allowance. You should claim the special allowance if:

- You are single and you have only one job at a time; or
- You are married, you have only one job at a time, and your spouse does not work; or
- Your wages from a second job or your spouse's wages (or the total of both) are $2,500 or less.

Head of household. You may claim one additional withholding allowance if you will file as head of household on your tax return. To find out if you qualify for head of household status, see Chapter 2.

Child and dependent care credit. You may claim one additional withholding allowance if you expect to have at least $1,500 of qualifying child or dependent care expenses for which you plan to claim a credit on your tax return. For information on this credit, see Chapter 33. Instead of claiming an additional allowance under this rule, you may choose to figure allowances for the child and dependent care credit (and other credits you expect to claim on your return) as explained next under *Additional allowances.*

Additional allowances. If you expect to itemize your deductions or have adjustments to income on your tax return, you may be able to claim additional withholding allowances. The Form W–4 Deductions and Adjustments Worksheet may be used to figure your additional allowances. You may also figure additional allowances for tax credits on the worksheet, using special tables to change the credit amount to an equivalent deduction amount. See Publication 505 for information.

Reducing allowances. You may need to reduce the number of withholding allowances you would otherwise claim if:

- You expect to receive nonwage income that is not exempt from tax or
- You have more than one job or a working spouse.

This reduction may be necessary to avoid underwithholding (see *Withholding and estimated tax,* earlier).

To figure the number of allowances to claim if you will receive nonwage income, you may use the Form W–4 Deductions and Adjustments Worksheet. The Two-Earner/Two-Job Worksheet, lines 1 through 3, may be used to figure the number of allowances to claim if you have two jobs or a working spouse.

For more information about Form W–4 and a filled-in example, see Publication 505.

Getting the Right Amount of Tax Withheld

You will most likely have too little tax withheld and owe tax at the end of the year if any of the following situations applies to you:

- You are married and both you and your spouse work;
- You have more than one job at a time;
- You have nonwage income, such as interest, dividends, alimony, or self-employment income; or
- You will owe additional amounts with your return, such as a supplemental Medicare premium (see *New tax law,* earlier).

In some instances, you may have too much tax withheld.

Checking your withholding. After you have filed a Form W–4 with your employer, the amount of tax withheld from your pay may be too little or too much. You should check to see if you need to adjust the amount of tax being withheld.

Publication 919, *Is My Withholding Correct for 1989?* will help you determine whether you are having the right amount of tax withheld. If your withholding is incorrect, you may have to file a new Form W–4. If too little tax is withheld, you may owe tax and a penalty. In that case, you should reduce your withholding allowances, or complete line 5 of Form W–4 to have an additional amount withheld each payday. Publication 919 will help you determine how much to increase the amount withheld to avoid owing tax when you file your return. If too much tax is withheld, see the 1989 Form W–4 instructions to see if you can decrease your withholding by claiming any allowances that you may be entitled to and have not already claimed.

When to change allowances. Events may take place that will change the exemptions, adjustments, deductions, and credits you can take on your tax return. When this happens, you may also have to change your withholding allowances to make sure you are having the right amount withheld.

If you find that you are no longer entitled to an allowance you have claimed, you must file a new Form W–4 within 10 days. Generally, you may file a new Form W–4 at any time you wish to change your withholding allowances for any other reason.

If you become aware of changes in 1989 that will decrease your allowances for 1990, you must file a new Form W–4 by December 1, 1989, or, if the change occurs in December 1989, within 10 days after the change.

Part-year method. If you go back to work after a period of unemployment or if you work only part of the year, too much tax may be withheld. You may reduce your withholding by requesting your employer to use the part-year method. See Publication 505.

Rules Your Employer Must Follow

The following are some of the withholding rules that can affect how you fill out your Form W–4 and how you handle problems that arise. For other rules, see Publication 505.

Putting a new Form W–4 into effect. If you fill out a new Form W–4, your employer can put it into effect as soon as it is practical to do so. The deadline for putting it into effect is the start of the first payroll period ending 30 or more days after you turn it in.

No Form W–4 submitted. If you do not fill out and submit a Form W–4, your employer must withhold at the highest rate—as if you were single and claimed no allowances.

Repaying withheld tax. If you find that you are having too much tax withheld, you should give your employer a new Form W–4. Your employer cannot repay you any of the tax withheld under your old Form W–4.

However, if your employer has withheld more than the correct amount of tax for the Form W–4 you have in effect, you do not have to fill out a new Form W–4 to have your withholding lowered to the correct amount. Your employer is allowed to repay you the amount that was incorrectly withheld. If you are not repaid, you will receive credit on your tax return for the full amount actually withheld.

Exemption from Withholding

You may claim exemption from withholding if:

- Last year you did not owe any federal income tax and had a right to a full refund of all income tax withheld, and
- This year you do not expect to owe any federal income tax and you expect to have a right to a full refund of all income tax withheld.

If you are exempt, your employer will not withhold federal income tax from your wages. The exemption applies only to income tax, not to social security (FICA) tax.

Dependents. If you can be claimed as a dependent on another person's tax return (for example, on your parent's return), you may not be exempt. You usually ***cannot*** claim exempt status if you have any nonwage income, such as interest on savings, and expect your wages plus this nonwage income to add up to more than $500. See Publication 505 for more information.

Claiming exemption. To claim exemption, you must give your employer a Form W–4 with the appropriate entries completed.

Your employer must send the Internal Revenue Service a copy of your Form W–4 if you claim exemption from withholding and your pay is expected to usually be more than $200 a week. If it turns out that you do not qualify for exemption, the IRS will send both you and your employer a written notice.

If you claim exemption, but then expect that you will have to pay income tax after all, you must file a new Form W–4 within 10 days. If you are not having tax withheld in 1989, but you expect to have to pay income tax in 1990, you must file a new Form W–4 by December 1, 1989.

An exemption is good for only one year. You must file a new Form W–4 by February 15 each year to continue your exemption.

Penalties

If you make statements or claim withholding allowances on your Form W–4 that decrease the amount of tax withheld, and there is no reasonable basis for such statements or allowances at the time you prepare your Form W–4, you may have to pay a penalty of $500.

There is also a criminal penalty for willfully supplying false or fraudulent information on your Form W–4 or for willfully failing to supply information that would increase the amount withheld. The penalty upon conviction cannot be more than $1,000, or imprisonment for not more than one year, or both.

These penalties will apply if you deliberately and knowingly falsify your Form W–4 in an attempt to reduce or eliminate the proper withholding of taxes. A simple error—an honest mistake—will not result in a penalty.

Supplemental Wages

Supplemental wages include bonuses, commissions, overtime pay, and certain sick pay. Your employer or other payer of supplemental wages may withhold income tax from these wages at a flat rate of 20% or figure withholding using the same method used for your regular wages.

Withholding on Tips

The tips you receive while working on your job are considered a part of your pay. They must be reported on your tax return on the same line as your regular pay. However, unlike your regular pay, tax is not withheld directly from tip income. Nevertheless, your employer will take your tips into account when figuring how much to withhold from your regular pay. See Chapter 7 for information on reporting your tips to your employer.

Figuring the amount to withhold. The tips you report to your employer are counted as part of your income for the month you report them. Your employer will use the amount you report to figure your withholding for the month. There are two ways your employer can do this:

- By withholding at the regular rates on the sum of your pay plus your reported tips, or
- By withholding at the regular rates on your pay plus an amount equal to 20% of your reported tips.

Pay too low. If your regular pay is too low for your employer to withhold all the tax due on your pay plus your tips, you may give your employer money to cover the shortage.

If you do not give your employer money to cover the shortage, your employer will first withhold as much social security or railroad retirement tax as possible, and then withhold income tax up to the full amount of your pay. If not enough tax is withheld, you may have to make estimated tax payments. When you file your return, you may also have to pay any social security or railroad retirement tax your employer could not withhold.

Allocated tips. Your employer should not withhold income tax, social security tax, or railroad retirement tax on any allocated tips. Withholding is based only on your pay plus your ***reported tips***. Any incorrectly withheld tax should be refunded to you. See Chapter 7 for more information about allocated tips.

For more information on the withholding rules for tip income, see Publication 531, *Reporting Income From Tips.*

Withholding on Taxable Fringe Benefits

The fair market value of certain benefits that you receive from your employer is considered a part of your pay.

Generally, your employer must withhold income tax on the value of taxable noncash fringe benefits you receive.

When paid. For purposes of determining when and how much income tax to withhold, your employer may elect to treat certain fringe benefits as paid on a pay period, quarterly, semi-annual, annual, or other basis, provided that the benefits are treated as paid at least once a year. Your employer can treat the value of these benefits as paid to you on one or more dates during the year, even if you receive the entire benefit at one time.

Special rule. There is a special rule that your employer may use if the fringe benefit is neither the transfer of personal property of a kind normally held for investment nor the transfer of real property. This special rule allows your employer to treat the value of benefits actually provided to you during the last 2 months (or any shorter period) of the year as provided during the following year. If your employer uses the special rule, your employer must notify you of its use and of the period for which it has been used.

When to withhold. In general, your employer must withhold income tax when the benefit is considered paid to you.

If your employer withholds less than the required amount of income tax when the benefit is considered paid to you, your employer has until March 31 of the year after the benefit is paid to withhold from your pay the balance of the income tax paid on your behalf.

How much to withhold. Your employer may add the value of fringe benefits to your regular wages for a payroll period and figure the amount of income tax to withhold on the total or your employer can withhold income tax on fringe benefits at a flat rate of 20%.

Your employer can elect not to withhold income tax on the value of your personal use of a car, truck, or other highway motor vehicle that is provided by your employer. Your employer must notify you if this election is made.

Determining the value of fringe benefits. Generally, your employer must determine the actual value of fringe benefits paid to you during the year by January 31 of the following year. If the benefit is your personal use of a highway motor vehicle provided by your employer, your employer may determine either the actual value of your personal use or the actual value as if the entire usage of the vehicle was personal use. If your employer treats the entire usage of the vehicle as personal use in determining the value of the benefit paid to you, you may deduct the value of your business use of the vehicle on behalf of your employer on Form 1040, *U.S. Individual Income Tax Return.* Use Form 2106, *Employee Business Expenses,* to determine the value of your business use of the vehicle.

Reporting. Any taxable fringe benefits considered paid to you and income tax withheld for the benefits may be shown on a separate Form W-2, *Wage and Tax Statement.*

For information on reporting the value of fringe benefits considered paid to you, see Chapter 6.

For information on deducting automobile expenses for business use, see Chapter 19.

Withholding on Sick Pay

"Sick pay" is an amount paid to you to replace your regular wages while you are temporarily absent from work due to sickness or personal injury. To qualify as "sick pay," it must be paid under a plan to which your employer is a party.

If you receive sick pay from your employer or an agent of your employer, income tax must be withheld just as it is from your salaries and wages.

However, if you receive sick pay from a third party who is not acting as an agent of your employer, income tax will be withheld only if you choose to have it withheld. You can have income tax withheld only from the part of your sick pay that is paid for by your employer's contributions to the plan.

If you receive payments under a plan in which your employer does not participate, the payments are not sick pay and you cannot have income tax withheld from them.

Union agreements. If you receive sick pay under a collective bargaining agreement between your union and your employer, the amount of income tax withholding may be determined by the agreement. See your union representative or your employer for more information.

How to request withholding. If you choose to have income tax withheld from your sick pay, you must fill out Form W–4S, *Request for Federal Income Tax Withholding From Sick Pay.* Give the form to the payer of your sick pay. The payer must withhold according to your directions on the form.

On your Form W–4S, you must tell the payer the amount you want withheld from each payment. This amount:

- Must be in whole dollars unless the payer agrees otherwise,
- Must not be less than $20 a week, or the equivalent of $4 a day,
- Must be at least 10% if the payer agrees to permit percentage withholding, and
- Must not reduce the net amount of each payment you receive to less than $10.

If you receive a payment of sick pay that is more than or less than a regular full payment, the amount withheld will be increased or decreased in proportion. For example, for a full payment of $100, you request withholding of $25 (25% of $100). On a part payment of $80, your withholding will be $20 (25% of $80).

Form W–4S has a worksheet that you can use to figure the amount you want withheld.

If you do not request withholding. If you choose not to have income tax withheld from your sick pay, you may have to make estimated tax payments. If you do not pay estimated tax or have income tax withheld, you may have to pay a penalty. See *Estimated Tax* and *Underpayment Penalty,* later in this chapter.

Withholding on Pensions and Annuities

Unless you choose not to have any withheld, income tax will generally be withheld from distributions you receive on your pension or annuity. This includes distributions from:

- An individual retirement arrangement (IRA).
- A life insurance company under an endowment, annuity, or life insurance contract.
- A pension, annuity, or profit-sharing plan.
- A stock bonus plan.
- Any other plan that defers the time you receive compensation.

The amount withheld depends on whether you receive payments spread out over more than one year (periodic payments) or whether you receive all of the payments within one year (nonperiodic payments).

Periodic Payments

Withholding from periodic payments of a pension or annuity is figured in the same way as withholding from salaries and wages. To tell the payer of your pension or annuity how much you want withheld, fill out Form W–4P, *Withholding Certificate for Pension or Annuity Payments,* or a similar form provided by the payer. Follow the rules discussed earlier under *Withholding on Salaries and Wages,* to fill out your Form W–4P.

You can specify an additional amount to be withheld on line 3 of Form W–4P. You will probably want to have an additional amount withheld from each pension or annuity payment if you will owe a supplemental Medicare premium, as explained under *New tax law,* earlier.

Note: Military retirement pay is generally treated in the same manner as wages and not as a pension or annuity for income tax withholding purposes. Military retirees should use Form W–4, not Form W–4P.

The withholding rules for pensions and annuities differ from those for salaries and wages in the following ways:

1) If you do not fill out a withholding certificate, tax will be withheld as if you are married and are claiming three withholding allowances.
2) Your certificate will not be sent to the Internal Revenue Service regardless of the number of allowances you claim on it.
3) You can choose not to have tax withheld, regardless of how much tax you owed last year or expect to owe this year. You do not have to qualify for exemption. See *Choosing Not to Have Income Tax Withheld,* later.
4) If you do not give the payer your social security number (in the required manner) or the Internal Revenue Service notifies the payer, before any payment or distribution is made, that you gave it an incorrect social security number, tax will be withheld as if you are single and claiming no withholding allowances.

Nontaxable amount. A part of your pension or annuity may not be taxable. This part will be determined by rules discussed in Chapter 11. Income tax will not be withheld from the part of your pension or annuity that is not taxable. It is withheld only on the taxable part.

Nonperiodic Payments

Tax will be withheld at the rate of 10% on any nonperiodic payments you receive, unless they are part of a "qualified total distribution."

A qualified total distribution is payment within one year of your entire interest in a pension, profit-sharing, stock bonus, or qualified annuity plan. The amount of tax withheld from a qualified total distribution is specified in tables.

Because the withholding rates for nonperiodic payments do not depend on withholding allowances or whether you are married or single, Form W–4P is not used. The withholding rates are fixed; you cannot change the way tax is withheld. However, you can use Form W-4P to specify that an additional amount be withheld. You can also use Form W-4P to choose to have no tax withheld from nonperiodic payments or to revoke a choice to have no tax withheld.

Choosing Not to Have Income Tax Withheld

You may choose to have no income tax withheld from your pension or annuity, whether the payments are periodic or nonperiodic. The payer of your pension or annuity will tell you how to make this choice. If Form W–4P is used, check the box on line 1 to make this choice. This choice will stay in effect until you decide you want withholding.

If you do not give the payer your social security number (in the required manner) or the Internal Revenue Service notifies the payer, before any payment or distribution is made, that you gave it an incorrect social security number, your choice to have no tax withheld will not be honored.

If you choose not to have any income tax withheld from your pension or annuity, or if you do not have enough withheld, you may be required to make estimated tax payments. See *Estimated Tax*, later.

If you do not pay enough tax either through estimated tax or withholding, you may have to pay a penalty. This penalty is discussed later under *Underpayment Penalty*.

Outside United States. If you are a U.S. citizen whose residence address is outside the United States, you may **not** choose exemption from withholding on pension or annuity benefits. See Publication 505 for more information.

Revoking a choice to have no tax withheld. If you want to revoke your choice to have no tax withheld, the payer of your pension or annuity will tell you how. If the payer gives you Form W–4P, write "Revoked" by the checkbox on line 1 of the form.

For periodic payments, tax will be withheld as if you are married and claiming three allowances if you do not complete the rest of the form. If you want tax withheld at a different rate, you must complete the rest of the form.

Notice required of payer. The payer is required to send you a notice explaining the withholding rules relating to pensions and annuities.

Withholding on Gambling Winnings

Income tax is withheld from certain kinds of gambling winnings. The amount withheld is 20% of the proceeds (the amount of your winnings minus the amount of your bet).

Gambling winnings from the following sources are subject to income tax withholding:

- A state lottery, if the proceeds are more than $5,000.
- A wagering pool, sweepstakes, or lottery (such as a drawing or church raffle), if the proceeds are more than $1,000.
- Any other wager, if the proceeds are more than $1,000 and at least 300 times the amount of the bet. This includes wagers on horse races, dog races, and jai alai.

Winnings from bingo, keno, and slot machines are not subject to income tax withholding.

Form W–2G. If income tax is withheld from your gambling winnings, you should receive a Form W–2G, *Statement for Recipients of Certain Gambling Winnings*, showing the amount you won and the amount withheld.

Backup Withholding

For some types of payments you receive, the bank or business that pays you must file an information return (Form 1099) with the Internal Revenue Service (IRS). The information return shows how much you were paid during the year. It also includes your name and identification number (either a social security number or an employer identification number).

These payments generally are not subject to withholding. However, "backup" withholding is required in certain situations to insure that income tax is paid. Backup withholding can apply to most kinds of payments that are reported on Form 1099.

Under backup withholding, the business or bank that pays you must withhold, as income tax, 20% of the amount you are paid if:

- You do not give the business or bank your identification number in the required manner;
- The IRS notifies the business or bank that the identification number you furnished is incorrect;
- You are required, but fail, to certify that you are not subject to backup withholding; or
- The IRS notifies the business or bank to start withholding on the interest or dividends it pays you because you have underreported interest or dividends on your income tax return. The IRS will take this action only after it has mailed you four notices over a 120-day period.

See Publication 505 for more information.

Penalties. There are civil and criminal penalties for giving false information to avoid backup withholding. The civil penalty is $500. The criminal penalty, upon conviction, is a fine of up to $1,000, or imprisonment of up to one year, or both.

Advance Earned Income Credit

If you expect to qualify for the earned income credit for 1989, you may choose to get the credit in advance. Your employer will then include a portion of the credit regularly in your pay. See Chapter 35 to see if you are eligible for the earned income credit.

How to get advance payments. To get the credit in advance, you must fill out Form W–5, *Earned Income Credit Advance Payment Certificate.* Give the bottom part of the form to your employer. Keep the top part for your records. If you have more than one employer, you may give a certificate to only one of them. If you are married and both you and your spouse are employed, you may give a Form W–5 to your employer and your spouse may give a Form W–5 to his or her employer.

The Form W–5 you give to your employer for 1989 is good until December 31, 1989. If you expect to qualify for the earned income credit in 1990 and you want to receive advance payments, you must give your employer a new Form W–5.

Earned income limit. Your employer is not required to continue making advance payments to you once your earned income reaches $19,340 for 1989. This is because you will no longer be eligible for the credit.

If your status changes. If any of the information you provided on your Form W–5 changes, you must fill out a new form to give to your employer. You must give your employer a new form if:

- You no longer qualify for the earned income credit,
- Your spouse files a Form W–5 with his or her employer, or
- You no longer want to get advance payments.

Filing your return. If you receive advance payments in 1989, you ***must*** file Form 1040 or Form 1040A for 1989 even if you are not otherwise required to file an income tax return. You may not file Form 1040EZ.

If you receive advance payments of the earned income credit and later find that you do not qualify for the credit, you will have to pay it back when you file your Form 1040 or Form 1040A for 1989.

Estimated Tax

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. You may also have to pay estimated tax if the amount of income tax being withheld from your salary, pension, or other income is not enough.

Estimated tax is used to pay both income tax and self-employment tax (as well as other amounts that are reported on Form 1040). If you do not pay enough through withholding or by making estimated tax payments, you may be charged a penalty. If you do not pay enough by the due date of each of the payment periods (discussed later under *When to Pay Estimated Tax*), you may be charged a penalty even if you are due a refund when you file your income tax return. For information on when the penalty applies, see *Underpayment Penalty*, later.

Supplemental Medicare premium. As explained earlier under *New tax law*, if you will owe a supplemental Medicare premium for 1989 you should increase your withholding or estimated tax payments to cover the amount you will owe. The underpayment penalty will not apply to the supplemental Medicare premium until 1990.

Who Should Make Estimated Tax Payments

Generally, you should make estimated tax payments for 1989 if you figure that your estimated tax for 1989 (as determined under *How to Figure Estimated Tax*, later) will be $500 or more and you estimate that the total amount of income tax withheld and your credits will be less than the lesser of:

- 90% of the tax to be shown on your 1989 income tax return, or
- 100% of the tax shown on your 1988 income tax return (if your 1988 return covered all 12 months of the year).

If all of your 1989 income will be subject to income tax withholding, you probably do not need to make estimated tax payments.

Married taxpayers. In deciding whether you must make estimated tax payments for 1989, apply the rules discussed here to your 1989 separate estimated income. If you can make joint estimated tax payments, you may apply these rules on a joint basis.

You and your spouse can make joint payments of estimated tax even if you are not living together.

You and your spouse are not entitled to make joint estimated tax payments if you are separated under a decree of divorce or of separate maintenance. Also, you may not make joint estimated tax payments if either spouse is a nonresident alien or if you and your spouse have different tax years.

Whether you and your spouse make joint estimated tax payments or separate payments will not affect your choice of filing a joint income tax return or separate income tax returns for 1989.

If you and your spouse make joint payments and then file separate returns, you may divide your estimated tax payments between you. See *Estimated Tax* under *Credit for Withholding and Estimated Tax*, later.

Aliens. The requirements for making estimated tax payments also apply to resident and nonresident aliens. If you are a nonresident alien who must make estimated income tax payments, use Form 1040–ES(NR).

How to Figure Estimated Tax

To figure your estimated tax, you must estimate your taxable income for the year and your taxes and credits for the year.

When figuring your 1989 estimated tax, it may be helpful to use your income and deductions for 1988 as a starting point. You must be careful to make adjustments both for changes in your own situation and for changes in the tax law. For 1989, there are several important changes in the law. These changes are discussed under *New tax law* at the beginning of this chapter.

Form 1040–ES, *Estimated Tax for Individuals*, includes a worksheet to help you figure your estimated tax. Keep the worksheet for your records.

For additional information on how to figure your estimated tax for 1989, see Publication 505, *Tax Withholding and Estimated Tax*.

Estimated taxable income. Include all the income you expect to receive during the year, even income that is subject to withholding. However, do not include income that is tax exempt. Be sure to subtract all the adjustments to income and deductions you expect to take on your tax return, including itemized deductions and a $2,000 deduction for each exemption. If you can be claimed as a dependent on another person's return (such as your parent's return), you cannot claim a deduction for your own personal exemption.

If you do not expect to itemize deductions, subtract your standard deduction. The amount of your standard deduction will depend on your filing status, whether you or your spouse is age 65 or older or blind, and whether you can be claimed as a dependent on another person's return. For information on the 1989 standard deduction amounts, see Publication 505 or the instructions for Form 1040–ES.

Estimated taxes and credits. After you have estimated your taxable income, figure the income tax on your estimated taxable income. Use the 1989 Tax Rate Schedules in the Form 1040–ES instructions. For the special method that must be used to figure tax on the income of a child under 14 who has more than $1,000 of investment income, see Chapter 32.

Additional taxes and credits. To the income tax on your estimated taxable income, add any additional taxes you expect to pay in 1989. Additional taxes are the ones from Form 4970, *Tax on Accumulation Distribution of Trusts*, and Form 4972, *Tax on Lump-Sum Distributions*. Subtract from this total any tax credits you expect to have in 1989. These are the credits shown on lines 41 through 45 of the 1988 Form 1040. If your credits are more than your tax, use "zero" as the result.

Add in your expected self-employment tax. For 1989, the tax is 13.02% of the first $48,000 in self-employment income. Also add the alternative minimum tax, the tax from recapture of investment credit, the tax on premature distributions from retirement plans, any advance earned income credit payments, any section 72 penalty taxes, and the excise tax on golden parachute payments, if you expect to have them in 1989.

Add any supplemental Medicare premium you expect to owe for 1989. See *New tax law* at the beginning of this chapter for an explanation of the premium.

Finally, subtract any excess social security or railroad retirement tax you expect to have withheld in 1989, and the amount of income tax you expect to pay through withholding during the year.

When to Pay Estimated Tax

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return.The following chart gives the payment periods and due dates.

For the period:	Due date:
Jan. 1* through Mar. 31	April 15
April 1 through May 31	June 15
June 1 through Aug. 31	September 15
Sept. 1 through Dec. 31	January 15 next year**

*If your tax year does not begin on January 1, see *Fiscal year taxpayers*, later.

**See *January payment*, later.

If the due date for making an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday.

January payment. If you file your 1989 Form 1040 by January 31, 1990, and pay the rest of the tax you owe, you are not required to make the payment of your estimated tax that would be due on January 16, 1990.

To take advantage of this rule for the final payment of your 1988 estimated taxes, you must file your 1988 Form 1040 and pay the rest of the tax you owe by January 31, 1989.

Fiscal year taxpayers. If your tax year does not start on January 1, your payment due dates are the 15th day of the 4th month of your fiscal year, the 15th day of the 6th month of your fiscal year, the 15th day of the 9th month of your fiscal year, and the 15th day of the 1st month after the end of your fiscal year. You do not have to make the last payment listed above if you file your income tax return by the last day of the first month after the end of your fiscal year and pay all the tax you owe with your return.

When to Start

You do not have to make estimated tax payments until you have income on which you will owe the tax. If you have income subject to estimated tax during the first payment period, you must make your first payment by the due date for the first payment period. You may pay all your estimated tax at that time, or you may pay it in four installments, the first by the due date for the first payment period and the remaining installments by the due dates for the later periods.

If you first have income subject to estimated tax during a later payment period, you must make your first payment by the due date for that period. You may pay your entire estimated tax by the due date for that period or you may pay it in installments by the due date for that period and the due dates for the remaining periods. This is illustrated in the following chart:

If you first have income on which you must pay estimated tax:	Make a payment by:	Make later installments by:
On or before March 31	April 15	June 15 September 15 January 15 next year*
After March 31 and before June 1	June 15	September 15 January 15 next year*
After May 31 and before Sept. 1	September 15	January 15 next year*
After August 31	January 15 next year*	(Not applicable)

*See *January payment*, earlier.

To determine how much you should pay by each payment due date, see *How Much Estimated Tax to Pay*, later.

After making your first estimated tax payment, changes in your income, deductions, credits, or exemptions may make it necessary for you to refigure your estimated tax. You may use the *Amended Estimated Tax Schedule* in Form 1040–ES to refigure your estimated tax. Pay the balance of any estimated tax over your remaining payment periods.

Farmers and Fishermen

If you received at least two-thirds of your gross income for 1988 from farming or fishing or you expect to receive at least two-thirds of your 1989 gross income from farming or fishing, you have only one payment due date for estimated tax for 1989—January 16, 1990. The due dates for the first three payment periods, discussed earlier, do not apply to you.

Therefore, for your 1989 tax, you may either:

- Pay all your estimated tax by January 16, 1990, or
- File your Form 1040 by March 1, 1990, and pay all the tax that is due. You will not have a penalty for not paying estimated tax.

Fiscal year farmers and fishermen. If you are a farmer or fisherman, but your tax year does not start on January 1, you may either:

- Pay all your estimated tax by the 15th day after the end of your tax year, or
- File your Form 1040 by the 1st day of the 3rd month after the end of your tax year and pay all the tax that is due at that time.

For more information on estimated tax for farmers and fishermen, see Publication 505.

How Much Estimated Tax to Pay

You should pay enough estimated tax each payment period to avoid a penalty for that period. If you do not pay enough estimated tax each payment period, you may be charged a penalty even if you are due a refund when you file your income tax return. The penalty is discussed later under *Underpayment Penalty*.

Required Installment

Generally, your required installment, or ***estimated tax payment,*** for each of the four payment periods should be 25% of your ***required annual payment.***

Your estimated tax payments for 1989 include any overpayment on your 1988 return that you elect to apply to your 1989 estimated tax, any payments sent in with a payment-voucher from Form 1040–ES (discussed later), any amount withheld as income tax from amounts you receive during 1989, and any credit for excess social security, railroad retirement, or Medicare tax withheld during 1989.

The total of the amounts withheld during 1989, plus any credit for excess social security, railroad retirement, or Medicare tax withheld during 1989, will be considered as paid in four equal installments (one on the due date of each of the payment periods) unless you can establish when an amount was actually withheld. If you can establish when an amount was actually withheld, you can treat it as paid when it was withheld. You can elect this treatment separately with respect to amounts withheld from wages and all other amounts withheld that are considered estimated tax payments.

Your required annual payment is the lesser of 90% of the tax shown on your 1989 return or 100% of the tax shown on your 1988 return (if you filed a 1988 return that covered all 12 months of the year).

Annualized Income Installment

If you do not receive your taxable income evenly throughout the year (for example, your income from a repair shop you operate is much larger in the summer than it is during the rest of the year), you may be able to pay less than 25% of your required annual payment by the due dates of some of the payment periods and still not have to pay the underpayment penalty.

For information on how to compute your annualized income installment, see Publication 505.

You will not have to pay the penalty if, by the due date of each of the payment periods, you pay the lesser of your ***required installment*** or your ***annualized income installment.***

Farmers and Fishermen

If at least two-thirds of your gross income for 1988 or 1989 is from farming or fishing, your required annual payment for 1989 is the lesser of 66⅔% of the tax shown on your 1989 return or 100% of the tax shown on your 1988 return (if you filed one that covered all 12 months of the year).

Estimated Tax Payments Not Required

You do not have to make estimated tax payments if you will pay enough through withholding in each payment period to meet the lower of the required installment or the annualized income installment for that payment period. You also do not have to make estimated tax payments if you will pay enough through withholding to keep the amount you owe with your 1989 tax return under $500.

Avoiding the Penalty for Underpayment of Estimated Tax

You can be sure that you will pay enough estimated tax during 1989 to avoid the underpayment penalty if you filed a return for 1988 that covered all 12 months of the year and your estimated tax payments for each payment period for 1989 (when added to the amount withheld from your income for the period) are at least 25% of the following amount:

1) Your total tax for 1988 (line 53 of Form 1040, line 22 of Form 1040A, or line 9 of Form 1040EZ), minus
2) The total (if any) of your 1988 earned income credit, your 1988 credit for federal tax on fuels, and your 1988 overpayment of windfall profit tax.

However, as explained earlier in this section, you may be able to pay less than this amount and still avoid the underpayment penalty.

How to Pay Estimated Tax

There are two ways to make estimated tax payments:

- By crediting an overpayment on your 1988 return to your 1989 estimated tax, and
- By sending in your payment with a payment-voucher from Form 1040–ES.

Crediting an Overpayment

If you had an overpayment on your Form 1040 for 1988, you can apply all of it, or any part of it, to your estimated tax for 1989. On line 64 of Form 1040, write the amount you want credited to your estimated tax rather than refunded. The amount you have credited should be taken into account when figuring your estimated tax payments. You can use all the credited amount toward your first payment or you can spread it out in any way you choose among any or all of your payments.

Once you have asked that an overpayment be credited to your estimated tax for the next year, you cannot have that amount refunded to you, nor can you use it in any other way.

Using the Payment-Vouchers

Each payment of estimated tax must be accompanied by a payment-voucher from Form 1040–ES. If you made estimated tax payments last year, you should receive a copy of the 1989 Form 1040–ES in the mail. It will have payment-vouchers preprinted with your name, address, and social security number. Using the preprinted vouchers will speed processing, reduce the chance of error, and help save processing costs.

If you did not pay estimated tax last year, you will have to get a copy of Form 1040–ES from the Internal Revenue Service. After you make your first payment, you should receive a Form 1040–ES package in the mail, with the preprinted vouchers.

There is a separate payment-voucher for each of the four payment periods. Each one has the due date printed on it. Be sure to use the correct voucher. For information on how to complete the payment-vouchers, see the instructions for Form 1040–ES or Publication 505.

Mail the voucher and your payment to the address listed in the Form 1040–ES package for the place where you live. ***Do not*** enclose your estimated tax payment when mailing your tax return or use the address for mailing your return. Use the addressed envelopes that come with your vouchers, or use the address for your state shown in your Form 1040–ES package.

Credit for Withholding and Estimated Tax

When you file your 1988 income tax return, take credit for all the income tax withheld from your salary, wages, pensions, etc., and for the amount you paid as estimated tax for 1988. These credits are subtracted from your tax as determined on your 1988 return.

If you had two or more employers and were paid wages of more than $45,000 during 1988, too much social security, railroad retirement, or Medicare tax may have been withheld from your wages. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in Chapter 35.

Withholding

If you had income tax withheld during 1988, you should receive, by January 31, 1989, a statement showing your income and the amount that was withheld from it. Depending on the source of your income, you will receive:

- Form W–2, *Wage and Tax Statement*
- Form W–2P, *Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments*
- Form W–2G, *Statement for Recipients of Certain Gambling Winnings*
- A form in the 1099 series.

Forms W–2, W–2P, and W–2G. These forms are filed with your income tax return. You should get at least two copies of each form you receive. Attach one copy to the front of your federal income tax return. The other copy is for your records. Your employer may also give you copies to file with your state and local returns.

Form W–2

Your employer should give you a Form W–2 for 1988 by January 31, 1989. You should receive a separate form from each employer you worked for. If you stop working before the end of the year, your employer can give you your Form W–2 any time after you leave your job but no later than January 31 of the following year (or the next day that is not a Saturday, Sunday, or holiday if January 31 is a Saturday, Sunday, or holiday). If you ask for the form, your employer must give it to you within 30 days after receiving your written request or by January 31 if this 30-day period ends after January 31.

If you have not received your Form W–2 by January 31, you should ask your employer for it. If you do not receive it by February 15, call the Internal Revenue Service toll-free telephone number for your area. The number is listed in your Form 1040 or Form 1040EZ and Form 1040A instructions. You will be asked to give your employer's name and address and, if known, your employer's identification number.

Form W–2 shows your total pay and other compensation and the income tax and social security tax that was withheld during the year. Take credit for the withheld income tax on line 54 if you file Form 1040, line 23a if you file Form 1040A, or line 8 if you file Form 1040EZ.

Form W-2 will also show the total amount of any advance payments of the earned income credit (EIC) you received.

Form W-2 is used to report any taxable sick pay you received and any income tax withheld from your sick pay.

Form W-2P

You will receive a Form W-2P for your pension or annuity, whether or not any tax was withheld. For some types of pension payments, you will receive a Form 1099-R or Schedule K-1 of Form 1041 instead of Form W-2P.

Form W-2P shows the amount of your pension or annuity for the year, and the amount of any income tax withheld. Report the tax withheld on line 54, Form 1040. You cannot use Form 1040A or Form 1040EZ if you receive pension or annuity payments. See Chapter 11 for information on how to report your pension or annuity income.

Form W-2G

If you had gambling winnings, 20% may have been withheld as income tax. If tax was withheld, the person who paid you will give you a Form W-2G showing the amount you won and the amount of tax withheld. Report the amounts you won on line 22, Form 1040. Take credit for the tax withheld on line 54, Form 1040. If you have gambling winnings, you must use Form 1040; you cannot use Form 1040A or 1040EZ. See Chapter 30 for information on how to deduct gambling losses.

The 1099 Series

The forms in the 1099 series are not filed with your return. Keep these forms for your records. There are several different 1099 forms, including:

Form 1099-DIV, *Statement for Recipients of Dividends and Distributions*

Form 1099-G, *Statement for Recipients of Certain Government Payments*

Form 1099-INT, *Statement for Recipients of Interest Income*

Form 1099-MISC, *Statement for Recipients of Miscellaneous Income*

Form 1099-R, *Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.*

Form SSA-1099, *Social Security Benefit Statement*

Form RRB-1099, *Statement for Recipients of Payments by the Railroad Retirement Board.*

For some types of income reported on forms in the 1099 series, you may not be able to use Form 1040A or Form 1040EZ. See the instructions to these forms for details.

If you were subject to backup withholding on income you received during 1988, include the amount withheld in the total on line 23a, Form 1040A, or line 54, Form 1040.

Form Not Correct

If you receive a form with incorrect information on it, you should ask for a corrected form. The corrected Form W-2G or Form 1099 you receive will be marked "Corrected." A special form, Form W-2c, *Statement of Corrected Income and Tax Amounts*, is used to correct a Form W-2 or W-2P.

Form Received After Filing

If, after you file your return, you receive a form for income that you did not include on your return, you should report the income and take credit for any income tax withheld by filing Form 1040X, *Amended U.S. Individual Income Tax Return.* See *Amended Returns and Claims for Refund* in Chapter 1.

Separate Returns

If you are married, but file a separate return, you may take credit only for the tax withheld from your own income. Do not report any amount withheld from your spouse's income. However, different rules may apply if you live in a community property state.

Community property states. If you live in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin, and file a separate return, you and your spouse must each report half of all community income in addition to your own separate income. Each of you takes credit for half of all taxes withheld on the community income. If you are divorced during the year, generally each of you reports half of the community income and withholding on that community income for the period before the divorce.

For more information on these rules, and some exceptions, see Publication 555, *Community Property and the Federal Income Tax.*

Fiscal Years

On your tax return, you can take credit only for the income tax withheld during a single calendar year, even if your return is for a fiscal year. During your fiscal year, one calendar year will end and another will begin. You must claim credit for all the tax withheld during the entire calendar year ending in your fiscal year. You cannot claim credit for any of the tax withheld during the calendar year beginning in your fiscal year. However, if you receive a payment from which income tax has been withheld under the backup withholding rule, you take credit for the amount withheld on your tax return for your tax year in which you receive the payment.

For a more detailed discussion of how to take credit for withholding on a fiscal year return, see Publication 505.

Estimated Tax

Take credit for all your estimated tax payments for 1988 on line 55 of Form 1040. Include any overpayment from 1987 that you had credited to your 1988 estimated tax. You must use Form 1040 if you paid estimated tax. You cannot use Form 1040A or Form 1040EZ.

Name changed. If you changed your name, and you made estimated tax payments using your old name, you should attach a brief statement to the front of your tax return. The statement should explain when you made the payments, the amount of each payment, the address you sent the payments to, what your name was when you made the payments, and what your social security number is. The statement should cover payments you made jointly with your spouse as well as any you made separately.

Separate Returns

If you and your spouse made separate estimated tax payments for 1988 and you file separate returns, you may take credit only for your own payments.

If you made joint estimated tax payments, you must decide how to divide the payments between you. One of you may claim all of the estimated tax paid and the other none, or you may divide it in any other way you agree on. If you cannot agree, you must divide the payments in proportion to each spouse's individual tax as shown on your separate returns for 1988.

Divorced Taxpayers

If you made joint estimated tax payments for 1988 and you were divorced during the year, either you or your former spouse may claim all of the joint payments or you may each claim part of them. If you claim any of the joint payments on your tax return, enter your former spouse's social security number in the block provided on the front of Form 1040.

If you were divorced and remarried in 1988, enter your present spouse's social security number in the block provided on the front of Form 1040. Also, under the bold heading "Payment" to the left of line 55, write your former spouse's social security number, followed by "DIV."

Underpayment Penalty

If you did not pay enough tax either through withholding or by making estimated tax payments, you will have an underpayment of estimated tax and you may have to pay a penalty. The penalty is figured separately for each payment period, so you may owe the penalty for an early period even if you later paid enough to make up the underpayment. If you did not pay enough tax by the due date of each of the payment periods, you may owe a penalty even if you are due a refund when you file your income tax return.

Form 2210. If the amount you owe on your income tax return is $500 or more and more than 10% of your total tax, or if you underpaid your estimated tax for any of the payment periods, you can complete Form 2210, *Underpayment of Estimated Tax by Individuals and Fiduciaries*, to figure your penalty. Even if you paid your tax through withholding, the penalty is considered a penalty on underpaid estimated tax, because if you did not have enough tax withheld, you owe estimated tax.

If you owe the penalty and do not attach Form 2210 to your return, the Internal Revenue Service will compute the penalty you owe and send you a bill. However, if you wish to use the annualized income installment method or if you request a waiver of the penalty, you must attach Form 2210 to your Form 1040 when you file your return. You cannot use Form 1040A or Form 1040EZ if you made estimated tax payments or if you decide to file Form 2210.

See *Farmers and Fishermen*, later in this section, for special rules that apply to people who received at least two-thirds of their incomes from farming or fishing.

Exceptions

You do not have to fill out Form 2210 or pay any penalty if either of the following conditions apply:

Less Than $500 Due

You do not owe a penalty if the ***total tax*** shown on your return minus the amount you ***paid through withholding*** (including excess social security, railroad retirement, and Medicare tax withholding) is less than $500.

Total tax for 1988. For 1988, your total tax on Form 1040 is the amount on line 53 reduced by the total of the amounts on lines 51, 56, and 59, any uncollected social security or railroad retirement tax on tips included on line 53, and the tax on an IRA or a qualified retirement plan from Form 5329 (other than Part II) included on line 52. (If applicable, you may also be able to subtract all or part of your windfall profit tax overpayments.)

Your total tax on Form 1040A is the amount on line 22 minus the amount on line 23b. Your total tax on Form 1040EZ is the amount on line 9.

No Tax Liability Last Year

You do not owe a penalty if you had no tax liability last year, and you were a United States citizen or resident for the whole year. For this rule to apply, your tax year must have included all 12 months of the year.

You had no tax liability for 1987 if your total tax was zero or you were not required to file an income tax return.

Example. Ray was unemployed for most of 1987. He earned $1,700 before he was laid off, and he received another $2,500 in unemployment compensation afterwards. He had no other income and did not have to pay income tax or self-employment tax. He filed a return only to have his withheld income tax refunded to him. In 1988, Ray began regular work as an independent contractor. Because Ray did not have to pay any tax in 1987, the penalty for underpaying estimated tax does not apply to him in 1988, even if he made no estimated tax payments.

Total tax for 1987. If you filed Form 1040 for 1987, your total tax is the amount on line 53 reduced by the total of the amounts on lines 51, 56, and 59, any uncollected social security or railroad retirement tax on tips included on line 53, and the tax on an IRA from Form 5329 (other than Part II) included on line 52. (If applicable, you may also be able to subtract all or part of your windfall profit tax overpayments.)

Your total tax on Form 1040A for 1987 is the amount on line 20 minus the amount on line 21b. Your total tax on Form 1040EZ is the amount on line 9.

Underpayments

An underpayment is the excess of the required installment (or, if lower, the annualized income installment) for a payment period over the portion of the amount paid by the due date that is not applied to an underpayment for an earlier payment period.

Payments. Your payments include income tax withheld from your salary, pension, gambling winnings, etc., and excess social security, railroad retirement, and Medicare tax. These amounts are considered payments of estimated tax in equal installments on the required installment dates (usually four), unless you prove otherwise.

Payments applied to earlier underpayments. Your estimated tax payments are applied to any underpayments on earlier installments in the order in which the installments were required to be paid.

Example. The tax shown on Ivy Fields' 1987 return was $10,000. Her actual tax for 1988 (line 47, Form 1040) is $11,000. She does not claim any credits or pay any other taxes. Because $9,900 (90% of the $11,000 tax shown on her 1988 return) is less than $10,000 (the tax shown on her 1987 return), Ivy's required annual payment for 1988 is $9,900. Each required installment is $2,475 ($9,900 × 25%).

Ivy does not use the annualized income installment method because she received her income evenly throughout the year.

Ivy made the following estimated tax payments for 1988: June 15, 1988—$1,200; September 15, 1988—$2,800; and January 17, 1989—$2,800. Ivy had $1,600 withheld from her income during 1988. $400 is considered to have been withheld on the due date of each of the payment periods. Therefore, Ivy is considered to have made the following payments: April 15, 1988—$400; June 15, 1988—$1,600 ($1,200 + $400); September 15, 1988—$3,200 ($2,800 + $400); and January 16, 1989—$3,200 ($2,800 + $400).

Ivy figures how to apply her payments to each payment period as follows:

1st Payment Period		
Required installment		$2,475
Amount paid by due date		400
Underpayment for 1st period		$2,075
2nd Payment Period		
Required installment		$2,475
Amount paid by due date	$1,600	
Minus: Payment applied to underpayment for 1st payment period	1,600	
Payment applied to current installment		-0-
Underpayment for 2nd period		$2,475
Plus: Remaining underpayment for 1st period		475
Cumulative underpayment		$2,950
3rd Payment Period		
Required installment		$2,475
Amount paid by due date	$3,200	
Minus: Payment applied to underpayment for 1st payment period	475	
Balance	$2,725	
Minus: Payment applied to underpayment for 2nd payment period	2,475	
Payment applied to current installment		250
Underpayment for 3rd period		$2,225
4th Payment Period		
Required installment		$2,475
Amount paid by due date	$3,200	
Minus. Payment applied to underpayment for 3rd payment period	2,225	
Payment applied to current installment		975
Underpayment for 4th period		$1,500

A filled-in Form 2210 illustrating this situation can be found in Publication 505.

Amended returns. If you file an amended return by the due date of your original return, use the amounts shown on your amended return to figure your underpayment of tax. If you file an amended return after the due date of the original return, use the amounts shown on the original return.

However, if you and your spouse file a joint return after the due date to replace separate returns you originally filed by the due date, use the amounts shown on the joint return to figure any underpayment of tax. This rule applies only if both original separate returns were filed on time.

Overpayments. You will have an overpayment for any period for which your withholding and estimated tax payments were more than the total of any underpayments for earlier periods plus the lesser of the required installment or the annualized income installment for the period. If you have an overpayment for a period, carry it to the next period and add it to your withholding and estimated tax paid for that later period to determine any underpayment or overpayment for that later period.

Figuring an Underpayment

You will not have to pay the penalty if you made your 1988 estimated tax payments on time and the payment for each period was at least as much as either the required installment or the annualized income installment for the period. You can use Form 2210 to figure any underpayment. If you have an underpayment for any period, or if your payment for any period was less than the required installment for the period and you do not wish to have the Internal Revenue Service figure the penalty for you, attach Form 2210 to your Form 1040 and check the box below line 65, Form 1040.

You figure an underpayment using either the required installment or the annualized income installment. If you use the annualized income installment to figure your underpayment, you must attach Form 2210 to your Form 1040.

Required installment. You will not have an underpayment for any payment period in which your estimated tax payment, reduced by any amounts applied to underpayments in earlier periods, was paid by the due date for the period and was at least as much as the required installment for the period.

Your required installment for any payment period is the lesser of 22.5% of the tax shown on your 1988 return or 25% of the tax shown on your 1987 return (if your 1987 return covered all 12 months of the year). However, if the annualized income installment for any period is less than the required installment for the same period and you use the annualized income installment in figuring your underpayment, you must add the difference between the annualized income installment and the required installment to the required installment for the next period. If you also use the annualized income installment for the next payment period, you must add the difference between the annualized income installment for that period and the required installment (as increased) for that period to the required installment for the following payment period.

Tax shown on return. The tax shown on your return is the total tax as defined earlier under *Exceptions*.

Annualized income installment. You will not have an underpayment for any payment period in which your estimated tax payments, reduced by any amounts applied to underpayments in earlier periods, were paid by the due date for the period and were at least as much as the annualized income installment for the period.

To annualize your 1988 income and to figure your adjusted self-employment income for each period, use either the blank worksheets at the end of Publication 505 or the worksheets in the Form 2210 instructions.

Waiver of Penalty

The penalty for underpayment can be waived by the Internal Revenue Service if:

- You did not make a payment because of a casualty, disaster, or other unusual circumstance and it would be inequitable to impose the penalty, or
- You retired (after reaching age 62) or became disabled during the tax year a payment was due or during the preceding tax year, you had reasonable cause for not making the payment, and the underpayment was not due to willful neglect.

To claim the waiver, complete Part I of Form 2210 and write "WAIVER" in the bottom margin of page 1. Also, attach an explanation to the form, and show how much of the penalty is to be waived.

Waiver for partnership or S corporation owners. No penalty will be applied to an underpayment of estimated tax for the first quarter of 1988 by an owner of a partnership or S corporation that makes a section 444 election to use a tax year other than a required tax year. The penalty will be waived through August 15, 1988, on the amount of the first quarter underpayment caused by the election. For information on this election, see Publication 538, *Accounting Periods and Methods.*

If this waiver applies, attach a statement to Form 2210 explaining that you are eligible for a penalty waiver under "Notice 88–49, section III.B." Identify the partnership(s) or S corporation(s) (or both) and the portion of the penalty attributable to each.

Period of Underpayment

The penalty is applied to the number of days that the installment was not paid. You figure the period of the underpayment by counting the number of days after the due date of the installment to and including the date of payment, or April 17, 1989, whichever is earlier. If you are a fiscal year taxpayer, use the 15th day of the 4th month following the close of your fiscal year instead of April 17, 1989.

If you are a calendar year taxpayer, payments were due on April 15, June 15, and September 15, 1988, and January 17, 1989.

If you are a fiscal year taxpayer, payments were due on the 15th day of the 4th month, the 15th day of the 6th month, and the 15th day of the 9th month of your fiscal year, and the 15th day of the 1st month after the end of your fiscal year.

Periods and amounts of underpayment are figured by applying estimated tax payments to any underpayments of earlier installments in the order in which such installments were required to be paid.

Underpayment paid in two or more parts. If a payment of estimated tax is applied to an underpayment for an earlier period, but the payment is less than the underpayment, you will have more than one period of underpayment for the earlier period.

The first period of underpayment for any payment period will be from the day after the due date for the payment period to the date of the first applied payment. Later periods of underpayment for that payment period will be from the day after the due date for the payment period to the date of the next applied payment or April 15 of the following year, whichever is earlier.

To figure your penalty for a payment period with more than one period of underpayment, figure a penalty amount separately for each of the periods of underpayment using the number of days in each period of underpayment, the correct underpayment balance, and the appropriate penalty rates.

Example. In the example under *Underpayments,* Ivy Fields had a $2,075 underpayment for the first payment period. Her $1,600 payment for the second payment period and $475 ($2,075 – 1,600) of her payment for the third payment period were applied to the underpayment for the first period.

Ivy has two periods of underpayment for the first payment period. She figures the period of underpayment on $1,600 by counting the number of days after April 15, 1988 (the due date for the first payment period), through the date she made the payment for the second payment period. She figures the period of underpayment on $475 by counting the number of days after April 15, 1988, through the date she made the payment for the third payment period. Ivy's Form 2210 is shown in Publication 505.

Payment of your entire 1988 estimated tax liability or any balance due by January 17, 1989, or the filing of your 1988 income tax return and payment of the tax shown on the return by January 31, 1989, will **not** relieve you of the penalty if you did not pay the estimated income tax due earlier in your tax year. If you file your return and pay the tax due by January 31, 1989, you will have no penalty for the payment due in January and the periods of underpayment for earlier payment periods will end on the date of payment.

Figuring the Penalty

Two different penalty rates are used to compute the underpayment penalty for 1988. The rate from April 15, 1988, to September 30, 1988, is 10% a year. Beginning October 1, 1988, the rate is 11% a year.

To figure your penalty for the ***first, second, or third payment period,*** you must:

1) Divide by 366 the number of days after the payment due date through the date of payment or September 30, 1988, whichever is earlier.
2) Multiply the amount of your underpayment by 10%.
3) Multiply the result in (1) by the result in (2).
4) Divide by 366 the number of days after September 30, 1988, through the date of payment or December 31, 1988, whichever is earlier.
5) Multiply the amount of your underpayment by 11%.
6) Multiply the result in (4) by the result in (5).
7) Divide by 365 the number of days after December 31, 1988, through the date of payment or April 17, 1989, whichever is earlier.
8) Multiply the amount of your underpayment by 11%.
9) Multiply the result in (7) by the result in (8).
10) Add the results in (3), (6), and (9). This is your penalty for the payment period.

To figure your penalty for the ***fourth payment period,*** you must:

1) Divide by 365 the number of days after January 17, 1989, through the date of payment or April 17, 1989, whichever is earlier.
2) Multiply the amount of your underpayment by 11%.
3) Multiply the result in (1) by the result in (2). This is your penalty for the fourth payment period.

To figure your ***total penalty,*** add your penalties for each installment.

If you owe a penalty and you do not wish to have the Internal Revenue Service figure the penalty for you, attach Form 2210 to your Form 1040 and check the box below line 65. Show the amount of the penalty in the space provided.

If you owe tax on line 65, Form 1040, add the penalty to your tax due and show your total payment on line 65. If you are due a refund, subtract the penalty from the overpayment you show on line 62, Form 1040.

Farmers and Fishermen

Special rules for estimated tax payments by farmers and fishermen and the amount they must pay to avoid an underpayment penalty were discussed earlier under *When to Pay Estimated Tax.* If you are a farmer or a fisherman, you should figure the amount of your underpayment, whether any exceptions apply, and the amount of the penalty on Form 2210F, *Underpayment of Estimated Tax by Farmers and Fishermen.*

Part II
Income

The chapters in this part discuss many different kinds of income and explain what is and what is not taxed. Among other topics, they cover salaries and wages, tips, fringe benefits, disability income, interest income, dividends, social security benefits, pensions, annuities, and rental income and expenses. The final chapter has information you may want to consider if you are trying to shelter any of your income from tax. For information on the gains and losses that are reported on Schedule D (Form 1040), see Part III.

6. Wages, Salaries, and Other Earnings

Important Changes for 1988

Educational assistance provided by your employer. Beginning in 1988, the exclusion for educational assistance provided by your employer is no longer available. See *Educational assistance program,* later.

Overnight camp expenses. Beginning in 1988, overnight camp expenses paid by your employer for your dependent do not qualify for the dependent care exclusion. See *Dependent care assistance,* later.

Qualified retirement plans. Under certain types of retirement plans, you may have part of your pay each year put into one or more retirement accounts. The amount put into the accounts is not included in income until you withdraw it. See *Employer's payments to qualified plan,* later.

Generally, you must include everything you receive in payment for personal services in your gross income. In addition to wages, salaries, commissions, tips, and fees, this includes other forms of compensation such as fringe benefits and payments for certain expenses you incur. You must report income in the form of goods or services at the fair market value of the goods or services you received.

You must keep accurate records of all your earnings that are not subject to withholding. See *Recordkeeping* in Chapter 1.

Employee Compensation

This section explains many types of employee compensation. The subjects are arranged in alphabetical order followed by *Fringe Benefits, Disability Income,* and *Pension and Annuity Payments,* which are explained in greater detail.

Advance commissions and other earnings. If you receive advance commissions or other amounts for services to be performed in the future, and you are a cash method taxpayer, you must include these amounts in income in the year received.

If you repay unearned commissions or other amounts in the same year in which you received them, you reduce the amount includible in your income by the repayment. However, if you repay the unearned commissions or other amounts in a later tax year, you may deduct the repayment only as an itemized deduction on your Schedule A (Form 1040) for that year . However, if the repayment amount was more than $3,000, see *Repayments* in Publication 525, *Taxable and Nontaxable Income.*

Back pay awards. Amounts you are awarded in a settlement or judgment for back pay, including unpaid life insurance premiums and unpaid health insurance premiums, are included in your gross income. They should be reported to you by your employer on Form W–2.

Bonuses and awards paid to you for outstanding work are income shown on your Form W–2. These include prizes such as vacation trips for meeting sales goals. If a prize or award is in goods or services, you must include the fair market value of the goods or services in income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you. If you receive an award for length of service or safety achievement, see *Employee achievement awards* in Chapter 13.

Christmas gifts. If your employer gives you a turkey, ham, or other item of nominal value at Christmas or other holidays, the value of the gift is not income. However, if your employer gives you cash, a gift certificate, or similar item that you may easily exchange for cash, the value of the gift is extra salary or wages regardless of the amount involved.

Government cost-of-living allowances are generally not included in income of federal civilian employees stationed in Alaska, Hawaii, or outside the 48 contiguous United States. However, cost-of-living allowances received by U.S. federal court employees must be included in gross income.

Allowances and differentials that increase your basic pay as an incentive for taking a less desirable post of duty are part of your compensation and must be included in income. For example, your compensation includes Foreign Post, Foreign Service, and Overseas Tropical salary differentials. For more information, see Publication 516, *Tax Information for U.S. Government Civilian Employees Stationed Abroad.*

Interview expenses. If an employer asks you to appear for an interview and pays you an allowance, or reimburses you for your transportation and other travel expenses, you include in income on line 22, Form 1040, only the amount you receive that is more than your actual expenses.

Moving expense allowances or reimbursements are included in your salary or wages for the tax year in which you receive them. See Chapter 28.

Private unemployment fund. Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on line 22, Form 1040.

Property purchased from employer. If your employer allows you to buy property below its fair market value as compensation for your services, you must include in your income as wages the difference between the property's fair market value and the amount you paid for it.

Property received for services. If you receive property for your services, you generally must include its value in your gross income as wages. Property for services includes shares of corporate stock from your employer. You must include the fair market value of this property in the year you receive it. However, you may not have to include the value of the property in income in the year received, if the property is both nontransferable and subject to a substantial risk of forfeiture. For details, see *Restricted Property Received for Services* in Publication 525.

Dividends you receive on restricted stock are extra compensation to you. Restricted stock is stock you received from your employer and did not include in income because it was nontransferable and subject to forfeiture. Your employer should include these payments on your Form W–2. If they are also reported on a Form 1099–DIV, you should list them on Schedule B (Form 1040), with a statement that you have included them in wages. Do not include them in the total dividends received.

Dividends you receive on stock you chose to include in income in the year transferred are treated the same as any other dividends. Report them on line 9, Form 1040. For a discussion of dividends, see Chapter 9.

Severance pay is taxable. A lump-sum payment for cancellation of your employment contract is income in the tax year you receive it and must be reported with your other salaries and wages.

Accrued leave payment. If you are a federal employee and receive a lump-sum payment for accrued annual leave when you retire or resign, this amount will be included on your Form W–2.

If you resign from one agency and are reemployed by another agency, you may have to repay part of your lump-sum annual leave payment to the second agency. You may reduce gross wages by the amount you repaid in the same tax year in which you received it. You should attach to your tax return a copy of the receipt or statement furnished by the agency to which repayment is made to explain the difference between the wages on the return and the wages on your Forms W–2.

Sick pay. Amounts you receive from your employer while you are sick or injured are part of your salary or wages. This applies whether the payments were made directly by your employer, or by a welfare fund, a state sickness or disability benefit fund, an association of employers or employees, or an insurance company, if the plan was paid for by your employer. However, benefits received under an accident or health insurance policy for which you paid the premiums are ***not taxable.***

Railroad sick pay. If you receive sick pay under the Railroad Unemployment Insurance Act, these payments are taxable and you must include them in income. However, you do not have to include them in income to the extent they are for an on-the-job injury.

If you received income because of a disability, see *Disability Income,* later.

Social security tax paid by employer. If you and your employer have an agreement that your employer pays your social security tax without deducting it from your gross wages, your employer must include the amount of tax paid as wages reported on Form W–2. This payment is treated as wages for figuring your social security tax and your social security benefits. However, these payments are not treated as social security wages if you are a domestic worker employed in private homes or you are an agricultural worker.

Stock appreciation rights. If your employer grants you a stock appreciation right, you do not include it in income until you exercise the right. When you exercise the right, you are entitled to a cash payment equal to the amount the fair market value of the corporation's stock on the date of exercise has increased over the fair market value on the date the right was granted. You include the cash payment in your income in the year you exercise the right.

Stock options. You usually have taxable income when you receive a nonstatutory option to buy stock (or other property) as payment for your services. However, if your option is a statutory stock option—an incentive stock option or an option granted under an employee stock purchase plan—special rules generally delay the tax until you sell or exchange your shares of stock. For details, see Publication 525.

Unemployment compensation. You have to include in income all unemployment compensation you receive.

Types of unemployment compensation. Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state. It includes:

1) Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund,
2) Unemployment insurance benefits,
3) Railroad unemployment compensation benefits,
4) Disability payments from a government program paid as a ***substitute*** for unemployment compensation (amounts received as workers' compensation for injuries or illness are ***not*** unemployment compensation),
5) Trade readjustment allowances under the Trade Act of 1974,
6) Benefits under the Airline Deregulation Act of 1978, and
7) Unemployment assistance under the Disaster Relief Act Amendments of 1974.

If you contribute to a governmental unemployment compensation program, and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions.

Supplemental unemployment benefits received from a company-financed fund (and the employees did not contribute to the fund) are not unemployment compensation. However, they are fully taxable as wages subject to income tax withholding but not subject to social security or federal unemployment taxes.

You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. However, if you repay the benefits in a later year, you must include the full amount of the benefits you received in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to your gross income. Include the repayment on line 30, Form 1040, and put "Sub-pay TRA" in the space to the left of the total. If the amount you repay in a later year is more than $3,000, you may be able to take a credit against your tax for the later year instead of deducting the amount repaid. For information on this, see the discussion on *Repayments,* in Publication 525.

Private unemployment fund. Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on line 22, Form 1040.

Payments by a union. Benefits paid to you as an unemployed member of a union out of regular union dues are included in your gross income on line 22, Form 1040.

Guaranteed annual wage. Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages.

State employees. Payments made by a state to a state employee, not covered by the state's unemployment compensation laws, that are comparable to benefits under the state's unemployment compensation laws, are fully taxable. Report these payments on line 22, Form 1040.

Fraudulently received unemployment compensation is fully taxable and is reported on line 22, Form 1040.

Repayment of unemployment compensation benefits. If you repaid in 1988 unemployment compensation benefits you received in 1988, subtract the amount you repaid from the total amount you received and enter that amount on line 20, Form 1040. Write "repayment" and the amount you repaid on the dotted line to the left of line 20. If you repaid in 1988 benefits you included in income in a prior year, see *Repayments,* in Chapter 13.

Union benefits and dues. Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union may not be excluded from your salary or wages. You must include them in your income as wages.

You may be able to deduct some of these payments as a miscellaneous deduction if they are related to your job and if you itemize your deductions on Schedule A (Form 1040). You may deduct them whether you paid them directly to the union or had them deducted from your pay. See Chapter 30.

Strike and lockout benefits paid to you by a union from union dues, including both cash and the fair market value of other property, are usually includible in your income as wages. You may exclude these benefits from your income only when the facts show that the union intends them as gifts to you.

Withholding. Amounts withheld from your pay for income and social security taxes or savings bonds are considered received by you. They will be included in your wages on Form W–2. The same generally is true of amounts withheld for taxable fringe benefits, pensions, insurance, union dues, and other assessments.

If your employer uses your wages to pay your debts, or if your wages are attached or garnisheed, the full amount is considered received by you. Also included in your wages are fines or penalties withheld from your pay.

Fringe Benefits

The value of fringe benefits you receive from your employer is taxable and must be included in your income as compensation, unless the benefits are specifically excluded by law or you pay fair market value for them.

Some benefits which you must report in income include your personal use of an employer-provided car or aircraft or membership in a country club. For more information about fringe benefits, see Publication 525.

Certain fringe benefits you receive are specifically excluded by law. These include:

1) No-additional-cost service,
2) Qualified employee discount,
3) Working condition fringe benefit, or
4) De minimis (minimal) fringe benefit.

No-Additional-Cost Service

If your employer provides you with a service that is offered for sale to customers in the ordinary course of your employer's line of business in which you work, and your employer does not incur any substantial additional cost in providing this service to you, you will not have to include in income the value of these services. Examples of no-additional-cost services are free, or reduced-price, stand-by flights for airline employees and free telephone service to telephone company employees.

Non-excess capacity services are not eligible for exclusion as no-additional-cost services. For example, an employee's use of a stock brokerage firm to buy stock or a mutual fund to buy an interest in the mutual fund does not qualify. However, non-excess capacity services may be considered a qualified employee discount, discussed later.

Reciprocal agreements. You may exclude no-additional-cost services provided by a different employer who has written reciprocal agreement with your employer if the following conditions are met:

- The agreement states that employees of each employer who perform substantial services in the same line of business may receive no-additional-cost services from the other employer.
- The service provided to the employees is the same type provided to customers in the same line of business in which the employees perform substantial services.

- Neither employer incurs substantial additional cost in providing the service to the other's employees. If one employer pays a substantial amount to the other in connection with the agreement, that employer has incurred a substantial additional cost.

Recipient of services. The value of these no-additional-cost services will not have to be included in income if the services are offered to:

1) Any individual who is currently employed by the employer in the line of business,
2) A retired or disabled employee who was formerly employed in the line of business,
3) A surviving spouse of a current or former employee,
4) A spouse or dependent child of an employee (including a child whose parents have died and who has not reached age 25), and
5) Any partner who performs services for the partnership.

For purposes of item (4) above, a child of divorced parents is treated as a dependent of both parents, if the child can be claimed as a dependent by either parent. In addition, any use of air transportation by the parent of an employee of an airline or airline affiliate will be treated as use by the employee. This does not include the parent of a surviving spouse of a deceased, retired, or disabled employee.

Note: If these services are generally available only to highly compensated employees, then the value of the services cannot be excluded from the income of the highly compensated employees.

Qualified Employee Discount

If your employer allows you to buy qualified property or services (defined below) at a discount (a price that is less than the price it is sold for to customers), you will not have to include in income the value of the discount if:

1) The discount you get on property is not greater than the gross profit percentage of the price at which the property is offered for sale to customers, or
2) The discount you get on services is not greater than 20% of the price at which the services are offered for sale to customers.

The value of these qualified employee discounts also will not have to be included in income if the discounts are offered to a spouse, a dependent child, a former employee (if retired or disabled), or to a surviving spouse or dependent child (if both parents are deceased, the child must be under age 25) of an employee or former employee.

For purposes of these discounts, if your employer leases space in a department store, you will be treated as an employee of the department store.

Qualified property or services generally means any property (other than real property and personal property held for investment) or services offered for sale to customers in the ordinary course of your employer's line of business in which you work.

Note: If these discounts are generally available only to highly compensated employees, the value of the discount cannot be excluded from the income of the highly compensated employees.

Working Condition Fringe

You will not have to include in income the value of property or services provided to you by your employer if you would be allowed to take a business deduction for them had you paid for them. Examples of working condition fringe benefits are the business use of a company car and subscriptions to business periodicals provided to you by your employer.

Parking. You do not have to include in income the value of free parking facilities provided to you on or near your employer's business premises.

Demonstration car. If you are a full-time car salesperson and you are provided a demonstration car to use in the sales area of your car dealer's sales office, you will not have to include in income the value of the car if:

1) The car is provided mainly so you can help your employer,
2) There are substantial restrictions on your personal use of the car,
3) The car is currently in the inventory of the automobile dealership, and
4) The car is available for test drives by customers during your normal business hours.

De Minimis (Minimal) Fringe

You do not have to include in income a fringe benefit so small in value that it would be unreasonable or administratively impractical for your employer to account for it. Examples of minimal fringe benefits are occasional typing of personal letters by a company secretary, occasional personal use of your employer's copying machine, occasional parties for employees, occasional tickets to the theater or sporting events, discount transit passes not over $15 a month, and occasional supper money or taxi fares if you work overtime.

Certain eating facilities. If your employer operates an eating facility on or near the business premises for the benefit of employees, you will not have to include in income the difference between the cost of the meals and their fair market value. In order to qualify as a de minimis fringe, the yearly income from the facility must equal or be more than the cost of operating the facility, and the facility must be available to all employees and not primarily for the benefit of highly paid employees.

If the exclusion for meals at an employer-provided eating facility is not available, you must include in income the difference between the value of the meals and the amount you pay for them. However, you may be able to exclude the value of meals your employer provides to you for his convenience if certain conditions are met. See *Meals and Lodging,* later.

On-Premises Athletic Facilities

If your employer operates a gym or other athletic facility located on the business premises, you do not have to include in income the value of this fringe benefit. To qualify, substantially all the use of this facility must generally be by employees, spouses, and dependent children.

Group Life Insurance Premiums

Group-permanent life insurance premiums paid by your employer for you are ordinary income to you and must be reported as wages.

Group-term life insurance bought for employees. Payments for up to $50,000 of group-term life insurance coverage that is provided to you by your employer are not included in your income. However, employer payments for insurance over $50,000 must be included in your income. This rule applies even if you make an irrevocable assignment of your rights in the policy to another person who agrees to pay your part of the insurance premiums. The amount to include in income will be shown on Form W–2.

Key employees. If the group-term life insurance plan discriminates in their favor, key employees (or former key employees), will also have to include in income the cost of the first $50,000 of group-term life insurance coverage.

The amount to be included in income by a key employee is the ***greater*** of the ***actual*** cost of the coverage, or the cost figured based on the cost table (shown later).

For information on who is a key employee and when a group-term life insurance plan discriminates in favor of key employees, see Publication 535, *Business Expenses.*

Retired employees. If you are a retired employee, you will also have to include in income the cost of this insurance coverage. However, this rule does not apply if you retired on or before January 1, 1984, and were covered by the plan when you retired. The rule also does not apply if you:

1) Retired after January 1, 1984, and before January 1, 1987, if:
    a) You were age 55 on or before January 1, 1984, and
    b) The plan was maintained by the same employer for whom you worked during 1983, or by a successor employer, or
2) Retire after December 31, 1986, if:
    a) Items 1(a) and (b) apply, and
    b) The plan, after 1986, meets the nondiscrimination rules.

Group-term life insurance is term life insurance protection (insurance for a fixed period of time) that:

1) Provides a general death benefit that is excludable from income,
2) Is provided to a group of employees,
3) Is provided under a policy carried by the employer, and
4) Provides an amount of insurance for each employee based on a formula that prevents individual selection.

If you pay any part of the cost of the insurance, your entire payment reduces, dollar for dollar, the amount you would otherwise include in your income. However, you may not reduce the includible amount by your payments for future year coverage, by your prepayments for coverage after retirement, or by the payments you make for insurance for which your employer's payments are not taxed to you because of the exceptions discussed below.

Permanent benefits. If your group-term life insurance policy includes permanent benefits, such as a paid-up or cash surrender value, you must include in your income, as wages, the cost of the permanent benefits, reduced by the amount you pay for them. Your employer should be able to tell you the amount to include in income.

Accidental or other death benefits in policies that do not provide general death benefits (for example, travel insurance) are not included as group-term life insurance coverage.

Exceptions. You are not taxed on the cost of this insurance if:

1) The coverage is provided after you have retired because of disability, or
2) Your employer is the beneficiary of the policy for the entire period the insurance is in force during the tax year, or
3) The only beneficiary is a qualified charitable organization (defined in Chapter 26) for the entire period the insurance is in force during the tax year. You are not entitled to a deduction for a charitable contribution by naming a charitable organization as the beneficiary of your policy.

You are taxed on the entire cost of group-term life insurance protection provided by your employer through a qualified employees' trust, such as a pension trust or a qualified annuity plan.

Full-time life insurance agents who are considered employees for social security tax purposes are treated as employees in applying the provisions relating to group-term life insurance under a policy carried by their employer.

If you have only one employer and you were insured at any time during the tax year for more than $50,000 under a group-term life insurance policy, your income from this source is shown as other compensation on the Form W-2 you receive.

If two or more employers provide you group-term life insurance coverage, totalling more than $50,000, you must figure how much to include in income for the cost of all coverage that is more than $50,000. You must include the cost of life insurance provided to you during the tax year, regardless of when your employers paid the premiums.

You figure the cost for each month of coverage by multiplying the number of thousands of dollars of insurance coverage, less $50,000 of insurance, figured to the nearest tenth, by the cost from the following table. You must prorate the cost if less than a full month of coverage is involved.

COST PER $1,000 OF PROTECTION FOR ONE MONTH

Age	Cost
Under 30	8 cents
30 through 34	9 cents
35 through 39	11 cents
40 through 44	17 cents
45 through 49	29 cents
50 through 54	48 cents
55 through 59	75 cents
60 and older	$1.17

Example. You are 51 years old and work for employers A and B. Both employers provide group-term life insurance coverage for you. Your coverage with employer A is $35,000, and your coverage with employer B is $45,000. You pay premiums of $50 a year under the employer B group plan. You figure the amount to include in your income as follows:

Employer A coverage (in thousands)	$ 35
Employer B coverage (in thousands)	45
Total coverage (in thousands)	$ 80
Minus: Exclusion (in thousands)	50
Excess amount (in thousands)	$ 30
Multiply by cost per $1,000 per month, age 51 (from table)	.48
Cost of excess insurance for 1 month	$ 14.40
Number of full months coverage at this cost	12
Cost of excess insurance for tax year	$172.80
Minus: Premiums you paid	50.00
Cost included in income as wages	**$122.80**

Meals and Lodging

You do not include in income the value of meals and lodging provided to you and your family by your employer at no charge if the following conditions are met:

1) Meals are:
    a) Furnished on the business premises of your employer, and
    b) Furnished for the convenience of your employer.
2) Lodging is:
    a) Furnished on the business premises of your employer,
    b) Furnished for the convenience of your employer, and
    c) You are required to accept the lodging as a condition of your employment.

Your family, for this purpose, includes only your spouse and your dependents.

Lodging includes the cost of heat, electricity, gas, water, sewer service, and similar items that are needed to make the lodging habitable.

Faculty housing. If you are employed by an educational institution and you (or your spouse and dependents) are provided qualified campus lodging for use as a residence, you must include in income the excess of the fair rental value over the amount of rent you pay. See Publication 525.

Meals. Generally, you may exclude from income the value of meals provided to you during working hours to have you available for emergency calls, or because your employer's business restricts you to a short meal period (30 to 45 minutes).

If you receive a cash allowance or reimbursement from your employer for meals or lodging, you generally must include the cash allowance or reimbursement in income as wages. Your employer will not withhold income tax from it, but will include it as other compensation on your Form W-2. See Chapter 19 for information on how to report reimbursements.

For more details on meals and lodging, see Publication 525.

Other Fringe Benefits

Other fringe benefits you receive may be excluded from income.

Cafeteria plans. Cafeteria plans are separate written plans that allow participants (who must be employees) to choose among two or more benefits consisting of cash and qualified benefits. A "qualified benefit" includes any benefit that is not currently taxable to the participant upon receipt (such as group-term life insurance up to $50,000, coverage under an accident or health plan, and coverage under a dependent care assistance program).

The only taxable benefit that a cafeteria plan may offer is cash. Any qualified (nontaxable) benefit can be used in a cafeteria plan, other than scholarships and fellowship grants, educational assistance programs, and the fringe benefits (other than *Meals and Lodging*) previously discussed. Nontaxable benefits include group-term life insurance that is includible in gross income only because the amount of the insurance exceeds $50,000 or the insurance is on the life of the employee's spouse or children.

A participant is not considered to have received a taxable benefit from a cafeteria plan simply because the participant may choose among the benefits of the plan.

Nondiscrimination rules. A cafeteria plan may not discriminate in favor of highly compensated participants as to eligibility to participate in the plan or as to contributions or benefits. If the plan does discriminate, highly compensated participants must include in income the value of the benefits that could have been elected.

If qualified benefits provided to key employees are more than 25% of the total of these benefits provided for all employees under the plan, the key employee must include in income the value of the benefits that could have been elected.

The taxable benefits are treated as having been received or accrued in the tax year of the highly compensated participant or key employee in which the plan year ends.

Dependent care assistance. If your employer provided you with child care or disabled dependent care services to allow you to work, you may exclude (within certain limits) the amount your employer paid for the care. The amount you may exclude is limited to the smaller of your earned income, your spouse's earned income, or $5,000 ($2,500 if you are married filing a separate return).

Note: Beginning in 1988, overnight camp expenses paid by your employer from a qualified plan cannot be excluded as dependent care assistance.

For purposes of the earned income limit, if your spouse is a full-time student or incapable of self-care, your spouse will be considered to have earned $200 a month if you receive care for one dependent, or $400 a month if you receive care for two or more dependents.

Dependent care services are treated as incurred when the care is provided and not when you are billed or charged, or pay for the care.

If your dependent is cared for at your employer's place of business, the amount you may exclude from income is based on how often you use the facility and the value of the services.

The dependent care assistance must be provided under a separate written plan of your employer that does not favor highly compensated employees, and that meets other qualifications. Your employer can tell you if the plan qualifies for the exclusion.

Note. To claim the exclusion for 1989 you will have to include on your tax return the name, address, and taxpayer identification number of the dependent care provider.

Educational assistance. You generally must include in income, as wages, any amount your employer paid for educational expenses for you.

Exception. If the educational courses are required by your employer or are job-related, and your employer either pays the expenses directly to the educational organization or reimburses you for the expenses after you make a full accounting, you may not need to include the amount paid by your employer in income.

In other cases, you may be able to deduct the expenses under the rules explained in Chapter 29. You must include in income stipends paid by your employer when you are on educational leave.

Educational assistance program. Beginning in 1988, the exclusion for educational assistance provided by your employer under a qualified plan is no longer available. All payments you receive under the plan for educational assistance must be included in income, unless they meet the exception discussed earlier. You may be able to deduct the expenses under the rules explained in Chapter 29.

Caution: As this publication was being prepared for print, Congress was considering legislation that would extend the exclusion through December 31, 1990. For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Qualified tuition reductions. If you receive a qualified tuition reduction (QTR), it is not includible in your income. A QTR is the amount of reduction in tuition for education (below the graduate level) that is furnished by an educational institution to an employee (or a person treated as an employee or certain other individuals) provided certain requirements are met. See *Qualified tuition reductions* under *Scholarships and Fellowship Grants* in Chapter 13.

Employer-provided transportation. The value of employer-provided transportation, such as a vanpool or similar shared usage arrangement, must be included in the gross income of each employee, including the driver, who commutes in the employer-provided vehicle.

Executive health program. If an employer pays the expenses of one of its executives for a health reconditioning and health restoring service provided at a resort hotel or athletic club, the amount paid is additional compensation. It is included in the executive's salary or wages.

Financial counseling fees paid by a corporation for its executives are includible in the executives' gross income and must be reported as part of wages. If the fees are for tax or investment counseling, they may be deductible by the executive as a miscellaneous deduction subject to the 2% of adjusted gross income limits on Schedule A (Form 1040).

Group legal services plan. Amounts paid for you, your spouse or dependents, by your employer for a qualified group legal services plan, and the value of the benefits received under the plan, may be excluded from income. See Publication 553.

Medical insurance premiums, including premiums for supplementary medical insurance (Medicare), paid for you, your spouse, and your dependents by your employer, or your former employer if you are retired, are not included in your income if provided under a qualified employer plan. You continue to be an employee during a layoff period for purposes of this benefit.

If your employer reimburses you for health insurance premiums after you verify you paid the premiums, the reimbursement is not included in income. Premiums paid by an employer for the benefit of a deceased employee's surviving spouse and dependents are also not included in income.

Highly compensated employees cannot exclude from their income payments made by their employer to a group health plan unless all of the employer's group health plans meet continuing coverage requirements. This rule does not apply to:

1) Plans maintained by employers who normally employed fewer than 20 employees on a typical day in the prior year,
2) Governmental plans, and
3) Church plans.

How To Report Fringe Benefits

Your employer reports your taxable fringe benefits on your Form W-2.

Employer-provided car. If your employer provides a car (or other highway motor vehicle) to you, your personal use of the car is a taxable noncash fringe benefit.

Your employer must determine the actual value of this fringe benefit to include in your income. This value may be determined by either of the following methods:

1) The actual value of your personal use of the car, or
2) The actual value of the car as if you used it entirely for personal purposes (100% income inclusion).

If your employer includes 100% of the value in your income, you may deduct the value of your business use of the car. You figure the value of this business use on Form 2106, *Employee Business Expenses.* For more information, see Publication 917, *Business Use of a Car.*

Accounting period. You must use the same accounting period that your employer uses to report your taxable fringe benefits. Your employer has the option to report taxable fringe benefits by either of the following rules:

1) The general rule, which is to value the benefit for a full calendar year (January 1–December 31), or
2) The special rule, which allows your employer to treat the value of benefits provided during the last two months of the calendar year (or any shorter period) as paid during the following calendar year. If this rule is used, your employer would, in the next year, include the value of benefits actually provided in the first 10 months of the current year and the last 2 months of the prior year.

If your employer uses the special accounting period rule to determine the amount to include in your income, you must use the same accounting period to claim an employee business deduction (for use of a car, for example). Your employer does not have to use the same accounting period for each fringe benefit, but is required to use the same period for all employees who receive a particular benefit. For more information, see Publication 917 and Publication 525.

Form W-2. Your employer reports your taxable fringe benefits in Box 10 (Wages, tips, other compensation) and, if applicable, Box 13 (Social security wages) of Form W-2, *Wage and Tax Statement.* The total value of your fringe benefits should also be shown in Box 16a. The value of your fringe benefits may be added to your other compensation on one Form W-2, or you may receive a separate Form W-2 showing just the value of your fringe benefits in Box 10 with a notation in Box 16a.

Disability Income

Generally, if you retire on disability, you must report your pension or annuity income. There is a tax credit for people who are permanently and totally disabled. If you retired on permanent and total disability, you may be eligible for the credit for the elderly or the disabled. For information on this credit and the definition of permanent and total disability, see Chapter 34.

Disability pensions. Generally, you must report as income any amount you receive for your disability through an accident or health insurance plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive for your disability that is due to your employer's payments is reported as income. However, certain payments may not be taxable. In addition to disability pensions and annuities, you may be receiving other payments for sickness and injury. Your employer should be able to give you specific details about your pension plan and tell you the amount you paid for your disability pension. See *Other Sickness and Injury Benefits* in Chapter 13.

If you pay the entire cost of a health or accident insurance plan, do not include any amounts you receive for your disability as income on your tax return. If your plan reimbursed you for medical expenses you deducted in an earlier year, you may have to include some, or all, of the reimbursement in your income. See *Reimbursement in a later year* in Chapter 23.

Accrued leave payment. If you retired on disability during the past year, any lump-sum payment for accrued annual leave you receive when you retire is a salary payment. The payment is not a disability payment. You should report it as wages in the tax year you receive it.

Retirement and profit-sharing plans. Any payment you receive from a retirement or profit-sharing plan that does not provide for disability retirement is not a payment from an accident or health plan. Therefore, you do not report as disability income the payments you received. The payments are taxable and you should report them as a pension or annuity. See *Disability Income* in Chapter 11.

Military disability pensions. Generally, you must report these disability pensions as income. But certain military and government disability pensions are not taxable. For more information, see *Military and Certain Government Disability Pensions* in Chapter 11.

How to report. Generally, you must report all your taxable disability payments on line 7, Form 1040, until you reach minimum retirement age. However, if you do not claim the credit for the elderly or the disabled, and you do not report the disability payments as pension or annuity income, you may use Form

1040A or Form 1040EZ. If you use one of these forms, report your disability payments on line 7, Form 1040A, or line 1, Form 1040EZ.

If you retired on disability, payments you receive are taxable as wages until you reach minimum retirement age. Minimum retirement age generally is the earliest age at which you may receive a pension or annuity whether or not you are disabled. Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension. Report the payments on line 17, Form 1040. These rules are explained in Chapter 11.

Pension and Annuity Payments

Generally, you may not exclude from income amounts you pay into a pension plan through payroll deductions.

Contributions to Federal Thrift Savings Fund. Federal employees can choose to make contributions, from their salaries, to the Federal Thrift Savings Fund. Contributions are not included in your income. Your salary of record before contributions are taken out is used for purposes of social security taxes and benefits. Payments from the fund are taxable as a distribution from a qualified pension or annuity plan.

Employer's payments to qualified plan. Generally, your employer's contributions into a qualified pension plan for you are not included in your income at the time contributed. However, employer contributions that are made out of funds that would otherwise have been paid to you as salary, except that you entered into a salary reduction agreement with your employer, are excludable from income only up to a limit.

For 1988 you may not set aside more than a total of $7,313 for all elective deferrals. If you set aside more than $7,313, the excess is included in your gross income that year. Contributions to tax-sheltered annuities are subject to a higher limit. See Publication 571, *Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations.*

The cost of life insurance coverage included in an employer's plan may be income if the proceeds of the policy are payable directly or indirectly to your beneficiary. See *Group Life Insurance Premiums,* earlier, under *Fringe Benefits.*

Amounts actually distributed or made available to you generally are taxable, unless they are eligible for tax-free rollover and are rolled over to another qualified plan or to an individual retirement account or annuity. Your employer can tell you how the amount you received is taxed. See Chapters 11 and 20.

Employer's payments to nonqualified plan. If your employer pays into a nonqualified plan for you, you generally must include the payments in your income as wages for the tax year in which the payments are made. However, if your interest is not transferable and is subject to a substantial risk of forfeiture, you need not include the amount of the contribution or premium payments in your income. When your interest becomes transferable or is no longer subject to a substantial risk of forfeiture, you must include the value in income.

Railroad retirement annuities. If you received the non-social security equivalent of tier 1 benefits, tier 2, or vested dual benefits, these payments are treated as pension or annuity income, and are taxable under the rules explained in Chapter 11.

Special Rules for Certain Employees

This section deals with special rules for people in certain types of employment. These employees are members of the clergy, people working for foreign employers, military personnel, veterans, and ACTION and Peace Corps volunteers.

Clergy

If you are a member of the clergy, you must include in income offerings and fees you receive for marriages, baptisms, funerals, masses, etc., in addition to your salary. If the offering is made to the religious institution, it is not taxable to you.

If you are a member of a religious organization and turn over your outside earnings to the organization, you nevertheless must include the earnings in your income. However, you may be entitled to a charitable contribution deduction for the amount paid to the organization.

Rental value of a home. You do not have to include in income the rental value of a home (or utility expenses) provided to you as part of your pay for your duties as an ordained, licensed, or commissioned minister. However, you must include the rental value of the home, and related allowances, as earnings from self-employment on Schedule SE (Form 1040) for purposes of the social security self-employment tax.

A housing allowance paid to you as part of your salary is not income to the extent you use it, in the year received, to provide a home or to pay utilities for a home with which you are provided. The amount of the housing allowance that you may exclude from income may not be more than the reasonable compensation for your services as a minister. The church or organization that employs you must officially designate the payment as a housing allowance before the payment is made. A definite amount must be designated; the amount of the housing allowance may not be determined at a later date.

If you are employed and paid by a local congregation, a resolution by a national church agency of your denomination does not effectively designate a housing allowance for you. The local congregation must officially designate the part of your salary that is to be a housing allowance. However, a resolution of a national church agency can designate your housing allowance if you are directly employed by the agency. If no part has been officially designated, you must include your total salary in income.

Expenses of providing a home include rent, house payments, furniture payments, costs for a garage, and utilities. They do not include the cost of food or servants.

If you own your home, or are buying it, you may exclude your housing allowance from income if you spend it for the down payment on the home, for mortgage payments, or for interest, taxes, utilities, repairs, etc. However, you may not exclude more than the fair rental value of the home plus the cost of utilities, even if a larger amount is designated as a housing allowance. Fair rental value of a home includes the fair rental value of furnishings in it.

You are allowed a deduction for the mortgage interest and real estate taxes you pay on your home whether or not you use nontaxable housing allowance funds to make the payments. See Chapters 24 and 25.

Teachers or administrators. If you are a minister employed as a teacher or administrator by a church school, college, or university, you are, for purposes of the housing exclusion, performing ministerial services. However, if you perform services as the head of a religious department, or as a teacher or administrator on the faculty of a non-church college, and if your specific duties involve no religious functions, you may not exclude from income a housing allowance or the value of a home that is provided to you. However, if you live in qualified campus housing as an employee of an educational institution, you do not have to include the value of that housing in income if you pay rent equal to or greater than the fair rental value of the housing.

If you serve as a "minister of music" or "minister of education," or serve in an administrative or other function of your religious organization, but are not authorized to perform all of the religious duties of an ordained minister in your church, even though you are commissioned as a "minister of the gospel," you may not exclude from income a housing allowance or the value of a home provided to you.

Theological students. You may not exclude a housing allowance from income if you are a theological student serving a required internship as an assistant pastor, unless you are ordained, commissioned, or licensed as a minister.

Traveling evangelists. You may exclude amounts received from out-of-town churches for evangelistic services if you are an ordained minister, if those amounts are designated as housing allowance, and you actually use them to maintain your permanent home. If you rent out your home while traveling, you may exclude only the part of the housing allowance you spend while living at home.

Retired members of the clergy. The rental value of a home provided rent-free by your church for your past services is not income if you are a retired minister. In addition, a housing allowance paid to you is not income to the extent you spend it for utilities, maintenance, repairs, and similar expenses directly related to providing a home.

The general convention of a national religious denomination may designate a housing allowance for retired ministers, if the local congregations authorize the general convention to establish and maintain a unified pension system for all retired clergy members of the denomination for their past services to the local churches.

A surviving spouse of a retired minister may not exclude a housing allowance from income. It must be reported on line 17 of Form 1040.

A pension or retirement pay for a member of the clergy is usually treated as any other pension or annuity. (See Chapter 11.) If you are not expected to perform any further services, payments from the congregation may be gifts. They are not taxable if they are based solely on your financial needs and the financial capacity of the congregation. If these payments are made under a legal agreement, an established plan, or because of past practice, they do not qualify as nontaxable gifts.

Members of religious orders. If you are a member of a religious order who has taken a vow of poverty, the amounts you earn for services you perform and which you renounce and turn over to the order, may or may not be includible in your income depending on whether you are considered to be performing the services as an agent of the order in the exercise of duties required by the order.

Services performed for the order. If your order directs you to perform services for another agency of the supervising church, or an associated institution, you are considered to be performing the services as an agent of the order. Any wages you earn as an agent of an order, and which you turn over to the order, are not includible in your gross income.

Example. You are a member of a church order and have taken a vow of poverty. You renounce any claims to your earnings and turn over to the order any salaries or wages you earn. You are a registered nurse, so your order assigns you to work in a hospital that is an associated institution of the church. However, you remain under the general direction and control of the order. You are considered to be an agent of the order and, therefore, any wages you earn at the hospital, and which you turn over to your order, are not includible in your gross income.

Services performed outside the order. If you are directed to take employment outside the order, the employment will not constitute the exercise of duties required by the order unless:

1) The services you perform are the kind that are ordinarily the duties of members of the order, and
2) The services you perform are part of the duties that are required to be exercised for, or on behalf of, the religious order as its agent.

Ordinarily, services will not be considered directed or required of you by the order if the legal relationship of employer and employee exists between you and a third party for whom you perform the services. When services are not considered to be directed or required of you by the order, the amounts you receive for the services are includible in your gross income. This is true even if you have taken a vow of poverty.

Example. Mark Brown is a member of a religious order and has taken a vow of poverty. All claims to his earnings are renounced and belong to the order.

Mark is a school teacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school. Mark became an employee of the school, and, as he requested, the school made the salary payments directly to the order.

Because Mark is an employee of the school, he is performing services as the school's agent rather than as an agent of the order through whom the order performs services for the school. Therefore, the wages Mark earns working for the school are includible in his gross income.

Foreign Employer

Special rules may apply if you work for a foreign employer.

U.S. citizen. If you are a U.S. citizen working for a foreign government, an international organization, a foreign embassy, or any foreign employer, you must include your salary in income.

Social security tax. You are exempt from social security employee tax if you are employed in the United States by an international organization or a foreign government. However, you must pay social security self-employment tax on your earnings from services performed in the United States. This rule also applies if you are an employee of a qualifying wholly-owned instrumentality of a foreign government.

Non-U.S. citizen. If you are not a U.S. citizen, or if you are a U.S. citizen but also a citizen of the Philippines, and you work for an international organization in the United States, your salary from that source is not taxable. If you work for a foreign government in the United States, your salary from that source is not taxable if your work is like the work done by an employee of the United States in that foreign country and if the foreign government gives an equal exemption for the salary of the U.S. employee.

Alien status. If you are an alien and give up your right to this exemption (by filing a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status), you are not entitled to the exemption from the date you give it up, unless you get the exemption from a treaty, consular agreement, or international agreement.

Pensions. This exemption applies only to employees. Pensions received by former employees living in this country do not qualify for this exemption.

Employment abroad. For information on income earned abroad, see Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

Military and Veterans

Payments you receive as a member of a military service generally are taxable except for certain allowances. Report them as wages. Veterans' benefits generally are not taxable.

Wages. Military pay taxable as wages includes:

- Active duty pay,
- Reserve training pay,
- Reenlistment bonus,
- Armed services academy pay,
- Amounts received by retired personnel serving as instructors in junior ROTC programs, and
- Lump-sum payments upon separation or release to inactive duty.

Military retirement pay based on age or length of service is taxable and must be included on line 17, Form 1040.

Nontaxable income.

- Annual round trip for dependent students
- Burial and death services (interment allowances)
- Combat zone compensation and combat related benefits
- Death gratuities
- Defense counseling
- Dental care for military dependents
- Dependent education
- Disability benefits
- Educational assistance
- Emergency assistance
- Evacuation allowances
- Family counseling
- Family separation allowances
- Forfeited pay
- Group-term life insurance
- Housing allowances
- Medical benefits
- Moving and storage
- Mustering-out payments (payments on discharge)
- Overseas cost-of-living allowances
- Premiums for survivor and retirement protection plans
- Professional education
- Quarters allowances
- Subsistence allowances
- Temporary lodging in conjunction with certain orders
- Travel for consecutive overseas tours
- Travel for consecutive overseas tours for dependents
- Travel in lieu of moving dependents during ship overhaul or inactivation
- Travel of dependents to a burial site
- Travel to a designated place in conjunction with reassignment in a dependent-restricted status
- Uniform allowance

Caution: As this publication was being prepared for print, Congress was considering legislation that would exclude the personal use of a vehicle from these benefits. For additional information on any late legislative changes see Publication 553, *Highlights of 1988 Tax Changes.*

Veterans' benefits under any law administered by the Veterans Administration are not included in gross income. The following amounts paid to veterans or their families are not taxable:

- Education, training, or subsistence allowances,
- Disability compensation and pension payments for disabilities,
- Grants for homes designed for wheelchair living,
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs, and
- Veterans' pensions paid either to the veterans or to their families.

Veterans' insurance proceeds and dividends are not taxable either to the veterans or to their beneficiaries. This also is true of the proceeds of a veteran's endowment policy paid before death.

Interest on dividends you leave on deposit with the Veterans Administration is taxable. The amount of this interest is shown on the statement the Veterans Administration gives you. If you decide to use accumulated dividends to buy additional paid-up National Service Life Insurance, neither the dividends nor the paid-up insurance is taxable.

Rehabilitation program payments. Veterans Administration payments to hospital patients and resident veterans for their services under the VA's therapeutic or rehabilitative program are included as income other than wages on line 22, Form 1040.

Volunteers

The tax treatment of amounts you receive as a volunteer worker for the Peace Corps, ACTION, or similar agency is covered in the following discussions.

Peace Corps

If you are a Peace Corps volunteer or volunteer leader, some amounts you receive may be exempt from tax.

Taxable allowances must be included in your income and reported as wages. These include:

- Cash allowances received during training,
- Allowance paid to your spouse and minor children while you are training in the United States,
- The part of living allowances designated by the President, under the Peace Corps Act, as basic compensation,
- Allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses,
- Leave allowances, and
- Readjustment allowances or "termination payments." These are considered received by you when credited to your account.

Example. Gary Carpenter, a Peace Corps volunteer, gets $175 a month during his period of service, to be paid to him in a lump sum at the end of his tour of duty. Although the allowance is not available to him until the end of his service, Gary must include it in his income on a monthly basis as it is credited to his account.

Nontaxable allowances include travel and living allowances for basic necessities, such as housing, utilities, food, clothing, and household supplies.

ACTION

ACTION participants perform services in antipoverty programs and older American volunteer programs.

VISTA. If you are a VISTA volunteer, you must include in your income as wages, meal and lodging allowances paid to you.

University Year for Action program. If you receive a stipend as a full-time student for service in the University Year for Action program, you must include the stipend in your income as wages.

Other Volunteer Programs

If you receive amounts for supportive services or are reimbursed for out-of-pocket expenses under any of the following volunteer programs, you do not include these amounts in your gross income:

- Retired Senior Volunteer Program (RSVP),
- Foster Grandparent Program,
- Senior Companion Program,
- Service Corps of Retired Executives (SCORE), and
- Active Corps of Executives (ACE).

Volunteer tax counseling for the elderly. You do not include in income any reimbursements you receive for transportation, meals, and other expenses you have in training for, or actually providing, volunteer federal income tax counseling for the elderly.

You may deduct as a charitable contribution your unreimbursed out-of-pocket expenses in taking part in the volunteer income tax assistance (VITA) program.

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7. Income from Tips

All tips you receive are taxable income and are subject to federal income tax. You must include in gross income tips you receive directly from customers, tips from charge customers that are paid to you by your employer, and your share of any tips you receive under a tip-splitting arrangement.

In addition, cash tips of $20 or more that you receive in a month while working for any one employer are subject to withholding of income tax and social security or railroad retirement tax. Employees report the tips they receive to their employers so that the correct amount of income and social security or railroad retirement tax can be determined. Withholding of income tax from tips is discussed in Chapter 5.

Your tips and other pay are used to determine the amount of social security or railroad retirement you will receive when you retire. You can get information about these benefits from Social Security offices or Railroad Retirement Board offices.

Every large food or beverage establishment must report to the Internal Revenue Service any tips allocated to its employees. Generally, tips must be allocated to employees when the total tips reported to an employer by employees are less than 8% of the establishment's food and beverage sales. See *Tip Allocation,* later.

Reporting Tips

You must report all tips as wages on Form 1040, Form 1040EZ, or Form 1040A, including the value of tips not paid in cash, such as passes, tickets, goods, or services. However, if you received tips of $20 or more in a month and you did not report all of them to your employer, you must file Form 1040.

The following discussions refer only to tips paid by cash, charge, and check.

If you receive less than $20 in tips while working for one employer during one month, you do not have to report them to that employer. But you must include the tips in gross income on your income tax return. There is no social security or railroad retirement tax on these tips.

If you receive tips of $20 or more in a month while working for any one employer, you must report the total amount of your tips to that employer by the 10th day of the next month.

Example 1. You work for Watson's Restaurant during the month and receive $75 in tips. Because your tips are more than $20 for the month, you must report the $75 to your employer.

Example 2. You work for Watson's Restaurant during the month and receive $17 in tips. In this same month you work for Parkview Restaurant and got $14 in tips. Even though your tips total $31, you do not have to report them to either employer because you received less than $20 in tips from each job. However, you should keep a record of the $31 because you must report it as income on your tax return.

Tip splitting. If you split tips with fellow employees, such as waiters giving a part of their tips to busboys, include only your share of the tips in your report to your employer.

Service charges. A club, hotel, or restaurant may require customers who use its dining or banquet rooms to pay a service charge, which is given to the waiters or waitresses and other employees. Your share of this service charge is not a tip, but is part of your wages paid by the employer. You should not include your share in your report of tips to your employer. Your employer should not include your share of the service charge in tips paid to you, but should include it as part of your wages.

Your tips are treated as paid to you when you make your report to your employer. However, if you make no report to your employer, your tips are treated as paid to you when you receive them.

Example 1. During December 1988, you received $75 in tips. On January 9, 1989, you reported the tips to your employer. Your December 1988 tips will be treated as paid to you in January 1989, at the time you made the report to your employer. You must report the $75 on your 1989 income tax return.

Example 2. If during December 1988 your tips were only $18, you would not have to make a report to your employer. In this case your tips are treated as paid in December 1988, the time you actually received them. You must report the $18 on your 1988 income tax return.

Records and Reports

You must keep a ***daily record*** or ***other evidence*** to prove the amount of tip income you report on your return.

Daily record. Your daily record must show your name and address, your employer's name, and the establishment's name. It must also show, for each workday, the amount of cash and charge tips you received directly from customers or from other employees, the amount of tips you paid out to other employees through tip sharing, etc., and the names of the other employees to whom you paid out tips.

You must make the entries in your daily record on or near the date you receive the tip income.

You can use Form 4070–A, *Employee's Daily Record of Tips,* to keep this record.

Other evidence. If you do not keep a daily record of tips, you must maintain other evidence of the tip income you receive. This other evidence must be as credible and reliable as a daily record. This other evidence can be documentary evidence that shows tips added to a check and paid over to you or amounts paid for food or beverages with respect to which you would generally receive a tip. Examples of documentary evidence are copies of restaurant bills, credit card charges, or charges under any other arrangement containing amounts added by customers as tips.

To report tips to your employer, you may use Form 4070, *Employee's Report of Tips to Employer.* This form tells you what information you must report. If you do not use Form 4070, your report should include the amount of the tips, your employer's name and address, your name and address, your social security number, the month (or shorter period) covered, your signature, and the date of the report.

Publication 1244 has both Form 4070 and Form 4070-A.

Your personal records. You should keep with your personal records your daily tip record and a copy of the written reports you give your employer.

When to Report

You must give your employer a written report by the 10th day following the month you receive tips of $20 or more while working for that employer.

Saturday, Sunday, holiday rule. If the 10th day falls on a Saturday, Sunday, or legal holiday, you may give your employer the report on the next day that is not a Saturday, Sunday, or legal holiday.

Example. You must report tips of $20 or more you receive during May 1989 to your employer by Monday, June 12, 1989.

Your tip report to your employer should cover only one calendar month. But, your employer may require you to report your tips more often than once a month. For example, you may be required to report your tips weekly. In this case, you must make your report on the dates set by your employer.

When you stop working for your employer, you should report your tips of $20 or more to your employer at that time. If you do not report the tips when you stop working, you must give a statement to your employer before your final payday or by the 10th day following the month you receive the tips, whichever is earlier.

Withholding on Tips

Your employer must withhold social security or railroad retirement tax and any income taxes due on the tips you report. Your employer usually deducts the withholding due on tips from your regular wages. But you do not have to have income taxes withheld if you had no income tax liability last year and expect none this year. See *Exemption from withholding* in Chapter 5 for more information.

Employer's recordkeeping. Your employer may withhold an estimated amount from your wages to cover the tax on your tips. Your employer also may require your written tip reports more than once a month and may deduct the taxes due on your reported tips even though they do not yet total $20. If this is done, your employer must adjust the amount of taxes withheld from time to time, based on the actual amount of tips you report.

Form W-2. The Form W-2, *Wage and Tax Statement*, which you get from your employer, includes your reported tips in your regular wages. It also shows the social security and income taxes withheld on your tips.

Wages too small. If your regular wages are too small for your employer to withhold the taxes due on your tips, you may give your employer extra money to pay these taxes. Your employer will tell you how much is needed.

Your employer will apply these amounts first to social security or railroad retirement tax and then to income tax.

You may pay estimated tax instead of giving your employer extra money. See Chapter 5 for information on estimated taxes.

Uncollected employee social security tax on tips. Box 16 on your Form W-2 will show the amount of social security tax on tips that your employer was unable to withhold and for which you did not give your employer extra money to pay the taxes.

You must file Form 1040, report the amount of uncollected tax on tips, and pay it with your return, even though you do not otherwise have to file a return. Include the amount of uncollected employee social security tax on tips in the total on line 53 of Form 1040. On the dotted line next to this total, write "Uncollected Tax on Tips" and show the amount.

Limit on social security tax. For 1988, the wages you received from a non-railroad employer and the tips you reported to that employer were subject to the withholding of employee social security tax until they reached a total of $45,000. Your employer withheld this tax at the rate of 7.51%. If you worked for two or more employers and the total social security tax withheld was more than $3,379.50 for 1988, you may be due a refund or a credit. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in Chapter 35.

Limit on railroad retirement tax. Your pay and the tips you reported to your railroad employer during 1988 were subject to the withholding of tier 1 employee railroad retirement tax until they reached a total of $45,000. Your employer withheld this tax at the rate of 7.51%. In addition, your employer withheld tier 2 employee railroad retirement tax at the rate of 4.90% of the first $33,600 of your pay and tips. The maximum amount of employee railroad retirement tax that should have been withheld for services you performed during 1988 was $5,025.90 ($3,379.50 + $1,646.40). If you worked for two or more railroad employers and the total railroad retirement tax withheld was more than $5,025.90 for 1988, you may be due a refund or a credit. See *Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld* in Chapter 35.

Unreported Tips

If you received tips of $20 or more in any month but did not report all of them to your employer, you must figure your social security tax on the tips not reported. You should use Form 4137, *Computation of Social Security Tax on Unreported Tip Income*, and attach it to Form 1040. Enter the tax on line 51 of Form 1040. You also must include these tips in income on your Form 1040. You may not use Form 1040EZ or Form 1040A.

Employees subject to the Railroad Retirement Tax Act. If you received tips of $20 or more in any month and did not report them to your employer, you should contact your nearest Railroad Retirement Board office for information on how to determine the amount of railroad retirement tax on unreported tips and how you can get railroad retirement credit for all your tips. You should pay the railroad retirement tax on unreported tips when you file Form 1040. Enter the tax on line 51 in the *Other Taxes* section on page 2 of Form 1040 and write "RRTA" next to it on the dotted line. You also must include these tips in income on your Form 1040. You may not use Form 1040EZ or Form 1040A.

Penalty for failure to report tips. If you do not report tips to your employer as required, you may be subject to a penalty equal to 50% of the employee social security or railroad retirement tax, in addition to the tax that you owe.

If you did not report tips to your employer as required, you should attach a statement to your return explaining why you did not report them.

Tip Allocation

Large food or beverage establishments are required to report to the Internal Revenue Service certain additional information about tips.

How the rules work. If the rules on tip allocation apply to your employer's establishment, your employer may have to allocate to you a part of the excess of 8% (or some lower percentage) of the total sales of the operation over the total amount of tips reported by all tipped employees. However, no allocation will be made to you if you report tips at least equal to your share of 8% of total sales.

If the customers do not tip 8% on the average, either your employer or a majority of the directly-tipped employees may apply to have the allocation percentage reduced from 8%. However, it cannot be reduced below 2%.

The allocated amount will be reported by your employer on your Form W-2 (in Box 6), separate from your wages and reported tips. Your employer bases withholding only on wages and reported tips. Your employer ***should not withhold*** income, social security, or railroad retirement tax from the allocated amount. Any incorrectly withheld taxes should be refunded to you.

Regardless of whether you receive a tip allocation, you are required to report as income all tips received. The tip allocation amount may be added to your gross income unless you are able to prove a lesser amount with adequate records. The Internal Revenue Service may determine that you received a larger amount of tip income than is reflected by the tip allocation.

For more information on these requirements, see *Tip Allocation* in Publication 531, *Reporting Income From Tips*.

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8. Interest Income

In general, any interest that you receive or that is credited to your account and can be withdrawn is taxable income. (It does not have to be entered in your passbook.) Interest that was credited in 1988 on deposits that you could not withdraw because of the bankruptcy or insolvency of the financial institution may not have to be included in your 1988 income. For details, see *Interest income on frozen deposits*, later in this chapter. Other exceptions to the interest income reporting rule are also discussed in this chapter.

As an important part of your records, you should keep a list showing sources and amounts of interest received during the year.

You may deduct expenses you have in earning this income on Schedule A (Form

1040) if you itemize your deductions. See Chapter 30.

Passive activity income and losses. There are tax rules in effect which limit the amount of losses and tax credits you may claim when such losses and credits are derived from passive activities. Generally, only income from passive activities can be used to offset losses from passive activities. Consequently, you generally cannot use passive activity losses to offset your other income, such as your wages or your ***portfolio income,*** (that is, any gross income from interest, dividends, etc., that is not derived in the ordinary course of a trade or business). For more information about determining and reporting income and losses from passive activities, see Publication 925, *Passive Activity and At-Risk Rules.*

Tax on investment income of a child under age 14. If a child is under age 14 at the end of the year and has more than $1,000 of investment income (such as taxable interest and dividends), part of his or her investment income may be taxed at the parents' tax rate if either parent is alive at the end of the year. If these requirements are met, Form 8615, *Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000,* must be completed and attached to the child's tax return. If these requirements are not met, Form 8615 is not required and the child's tax is figured on his or her own tax rate.

The information contained in this chapter about interest income applies generally to all taxpayers, including children. For more information about the tax on investment income of certain children, however, see Chapter 32.

Beneficiary of an estate or trust. Interest, dividends, or other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.—1988,* from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the items from Schedule K-1 on your Form 1040.

Backup withholding. To ensure that income tax is collected on interest and other types of income that generally are not subject to withholding, "backup" withholding will apply in certain circumstances.

Under backup withholding, when you open a new account you must certify under penalties of perjury that your social security number is correct and that you are not subject to backup withholding. If you fail to make this certification, backup withholding may begin immediately on your new account or investment and 20% of the interest paid on your account will be withheld. Your payer will give you a Form W-9, *Request for Taxpayer Identification Number and Certification,* or a similar form to make this certification. Backup withholding may also be required if the Internal Revenue Service has determined that you underreported your interest and dividend income. For more information, see *Backup Withholding* in Chapter 5.

Social security number. You must give your name and social security number to the payer of interest. If you are married and the funds in a joint account belong to you, you should give your social security number to the payer of the interest. If the funds in the account are mixed, you may give either your number or your spouse's number, so long as the number you provide corresponds with the name listed on the account. You must give the payer the correct social security number if the number being used is wrong.

If you do not give your social security number to the payer of interest, you may have to pay a penalty. See *Penalty for failure to supply social security number* under *Penalties* in Chapter 1. Backup withholding also may apply. See Chapter 5.

Joint accounts. If two or more persons, such as you and your spouse, hold savings accounts, bonds, or other property that pays interest, as ***joint tenants, tenants by the entirety, or tenants in common,*** each person receives a share of any interest from the property. Each person's share is determined by local law.

Income from property given to a child. Property you as a parent give your child under a Model Gifts of Securities to Minors Act, a Uniform Gifts to Minors Act, or any law like either of these, is a true gift for federal gift tax purposes. Income from property transferred under these Acts is taxable to the child unless it is used in any way to satisfy a legal obligation of support of that child. The income is taxable to the person having the legal obligation to support the child (parent or guardian) to the extent that it is used for the child's support.

Savings account with parent as "trustee." Interest income derived from a savings account opened for a child or minor but placed in the name, and subject to the order, of the parents as trustees is taxable to the child, if, under the law of the state in which the minor resides:

1) The savings account legally belongs to the child, and

2) The parents are not legally permitted to use any of the funds to support the child.

Form 1099–INT. Form 1099–INT, *Statement for Recipients of Interest Income,* or a similar statement, is used by banks, savings and loans, and other payers of interest to show you the interest you received during the year. Keep this form for your records. You do not have to attach it to your tax return.

Report the total amount of interest income that is shown on any Form 1099–INT that you receive for the tax year. Even if you do not receive Form 1099–INT, you must report all of your taxable interest income.

Reporting the tax withheld. If tax is withheld from your interest income, the payer must give you a Form 1099–INT that indicates the amount withheld.

Nominees. Generally, if someone receives interest as a nominee for you, that person will give you a Form 1099–INT showing the interest they received on your behalf.

If you receive a Form 1099–INT that includes amounts belonging to another person, see the discussion on nominee distributions, later, under *How to Report Interest Income.*

Incorrect amount. If you receive a Form 1099–INT that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The corrected Form 1099–INT you receive will be marked "CORRECTED."

Interest on Form 1099–OID. Reportable interest income may also be shown on Form 1099–OID, *Statement for Recipients of Original Issue Discount.* For more information about amounts shown on this form, see *Original Issue Discount (OID),* later in this chapter.

Negligence penalty on unreported interest income. If you are required to file a return and you receive Forms 1099 showing taxable amounts of income, such as interest payments, you must report these payments on your return. Failure to report any part of the payments will be treated as due to negligence in the absence of clear and convincing evidence to the contrary. Any additional tax due on this return will be subject to the 5% negligence penalty. The negligence penalty is applied to the entire amount of any underpayment of tax and not just to the part of the underpayment resulting from negligence. In addition, you will be subject to a related interest penalty equal to 50% of the interest due on the additional tax that is attributable to negligence.

Caution: As this publication was being prepared for print, Congress was considering legislation that would repeal the penalty of 50% of the interest on the underpayment due to negligence or fraud. Instead, it would make interest on the negligence and fraud penalties payable beginning on the last day for filing the return.

It would also restrict the negligence penalty, in cases of failure to include amounts shown on an information return, to the portion of the underpayment of tax due to such failure to report.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Individual Retirement Arrangements (IRAs). Interest that you earn on an IRA is not included in your income until you make withdrawals from the IRA. Nor is it included in the amount to be reported as tax-exempt interest. See Chapter 20.

Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information reporting requirement,* next.) You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends that you received. Exempt-interest dividends are not shown on Form 1099–DIV or Form 1099–INT.

Information reporting requirement. Although these dividends are not taxable, you must show them on your tax return if you are required to file. This is an information reporting requirement and does ***not*** convert tax-exempt interest to taxable interest. See *How to Report Interest Income,* later. Also, tax-exempt interest income on specified private activity bonds generally is a "tax preference item" and may be subject to the alternative minimum tax. See Chapter 31 for more information.

Dividends declared in December. For information about the tax treatment that may apply for any regulated investment company or mutual fund dividend declared in December, see the discussion under *Capital Gain Distributions,* in Chapter 9.

Interest income on frozen deposits. Under certain circumstances, you may choose to exclude from your income amounts of interest credited during 1988 on deposits that you could not withdraw by the end of 1988 because of the bankruptcy or insolvency of the financial institution, or because the state where the financial institution is located has placed limits on withdrawals because other banks in the state are bankrupt or insolvent.

The amount of interest you may exclude from gross income in 1988 is the interest that was credited on the frozen deposits minus the sum of:

1) The net amount you withdrew from these deposits during 1988, and
2) The amount you could withdraw as of the end of 1988 (not reduced by any penalty for premature withdrawals of a time deposit).

Report the excluded part of the interest in the gross income of the tax year in which it is withdrawable. If you receive a Form 1099–INT for interest income on deposits that were frozen at the end of 1988, see the specific instructions, later, in *Form 1040A* or *Form 1040*, as applicable, under *How to Report Interest Income*, for information about reporting this interest income exclusion on your 1988 tax return.

Taxable Interest

Interest you receive from bank accounts, loans you make to others, and most other sources is taxable. The following are some other sources of taxable interest.

Dividends that are actually interest. Certain distributions commonly referred to as dividends are actually interest. You must report, as interest, so-called "dividends" on deposits or on share accounts in:

Cooperative Banks
Credit Unions
Domestic Building and Loan Associations
Domestic Savings and Loan Associations
Federal Savings and Loan Associations
Mutual Savings Banks

Money market funds. Generally, amounts you receive from money market funds should be reported as dividends.

Money market certificates, savings certificates, and other deferred interest accounts. If you open any of these accounts, and interest is paid at fixed intervals of one year or less during the term of the account, you must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in one year or less and give a single payment of interest at maturity. If interest is deferred for more than one year, see *Original Issue Discount (OID)*, later.

Money borrowed to invest in money market certificate. The interest you pay on money borrowed from a bank or savings institution to meet the minimum deposit required for a 6–month money market certificate from the institution and the interest you earn on the certificate are two separate items. You must report the total interest you earn on the certificate in your income. You may deduct the interest you pay, as investment interest subject to certain limits, only if you itemize deductions.

Example. You deposit $5,000 with a bank and borrow $5,000 from the bank to make up the $10,000 minimum deposit required to buy a 6–month money market certificate. The certificate earns $575 at maturity in 1988, but you receive only $265, which represents the $575 you earned minus $310 interest charged on your $5,000 loan. The bank gives you a Form 1099–INT for 1988 showing the $575 interest you earned. The bank also gives you a statement showing that you paid $310 interest for 1988. You must include the $575 in your income. You may deduct $310 on Schedule A (Form 1040) if you itemize your deductions, subject to the investment interest expense limitation.

The fair market value of gifts or services you receive for making long-term deposits or for opening accounts in savings institutions is interest. Report it in income in the year you receive it.

Example. In 1988 you open a savings account at your local bank. The account earns $20, which is credited as interest. You also receive a $10 calculator. If no other interest is credited to your account during 1988, the Form 1099–INT you receive would show $30 interest income for 1988.

Interest on insurance dividends you leave on deposit with an insurance company that is credited annually and can be withdrawn annually on demand is taxable to you when the interest is credited to your account. However, if you can only withdraw it on the anniversary date of the policy (or other specified date), the interest is taxable in the year in which that date occurs.

Interest on GI insurance dividends you leave on deposit with the Veterans Administration is taxable.

Prepaid premiums. Any increase in the value of prepaid premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw. Your insurance company must give you a Form 1099–INT showing the interest you earned for the year if you had $10 or more of interest income from that company.

Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States, is taxable for federal income tax purposes, but is exempt from all state and local income taxes.

Treasury bills are issued at a discount and the interest is the difference between the discounted price you pay for the bills and the face value you receive at maturity. Report this interest income when the bill is paid at maturity. On Treasury notes and bonds, interest is paid at stated intervals by interest checks or by direct deposit to your designated account through the TREASURY DIRECT system. For more information, see *U.S. Treasury Bills, Notes, and Bonds* in Publication 550, *Investment Income and Expenses*.

For information on Series EE and Series HH Savings Bonds, see *U.S. Savings Bonds*, later.

Interest on tax refund. If you receive a tax refund that includes interest on the amount refunded, the interest is taxable.

Second trust notes. Installment payments you receive on second trust notes issued by other than a corporation and bought at a discount usually consist of the following three parts:

1) Interest, as stated in the terms of the note, which is taxed,
2) Return of capital, which is not taxed, and
3) Discount income, which is taxed as interest.

Example. You bought at 40% discount a $5,000, 6% second trust note payable at $50 a month. You received four payments in the first year totaling $200, of which $99.26 is interest and $100.74 is principal. Because 40% of the principal payment is discount income, you must add $40.30 (40% of $100.74) to the stated interest payment of $99.26. Therefore, your total taxable interest is $139.56. If you sell the note, see *Discounted debt instruments* in Chapter 16.

Interest on condemnation awards. If the condemning authority pays you interest to compensate you for a delay in paying an award, the interest is taxable.

Installment sale payments. Certain deferred payments you receive under a contract for the sale or exchange of property provide for interest that is taxable. If no interest is provided for in the contract, each payment will be treated as containing interest. The unstated interest rules apply to certain payments received on account of a ***seller-financed*** sale or exchange of property. See Publication 537, *Installment Sales*.

Accumulated interest on an annuity contract you sell before its maturity date is taxable.

Usurious interest is taxable unless state law automatically changes it to a payment on the principal. Usurious interest is interest charged at an illegal rate.

Accrued interest on bonds. If you sell bonds between interest payment dates, the accrued interest paid to you is taxable. See *Bonds Sold Between Interest Dates*, later.

Bonds traded flat. If you purchase bonds when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if later paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued. See *Bonds Sold Between Interest Dates*, later, for more information about these interest payments.

Interest on below-market interest rate loans. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. These loans are discussed in Chapter 25.

U.S. Savings Bonds

You may earn interest on U.S. Savings Bonds in one of two ways. On some bonds, interest is paid at stated intervals by interest checks or coupons. Other bonds are issued on a discount basis and the interest is the increase in their value over stated periods of time.

Series HH Bonds. These bonds are issued at face value. Interest is paid twice a year by check. If you are a cash method taxpayer, you must report interest on these bonds as income in the year you receive it.

Series HH Bonds were first offered in 1980. Before 1980, ***Series H Bonds*** were issued. Series H Bonds are treated the same as Series HH Bonds. If you are a cash method taxpayer, you must report the interest when you receive it.

Series EE Bonds. These bonds are issued on a discount basis. The face amount is payable only at maturity. The difference between the purchase price and the redemption value is taxable interest.

Series EE Bonds were first offered in 1980. Before 1980, ***Series E Bonds*** were issued. If you own either Series EE or Series E Bonds and use the cash method of reporting income, you may:

1) Defer reporting the interest until the earlier of the year you cash the bonds or the year in which they finally mature, or
2) Choose to report the increase in redemption value as interest each year.

If you want to change your method of reporting from method (1) to method (2), you may do so without permission from the Internal Revenue Service. However, in the year of change you must report all interest accrued to date and not previously reported for all such bonds.

Once you choose to report the interest each year, you must continue to do so for all Series EE or Series E Bonds you own and for any you get later. You may not change from method (2) to method (1) without permission to do so. See *Changing your accounting method* under *Accounting Periods and Methods* in Chapter 1.

If you hold the bonds beyond the original maturity period, and you have chosen to report the interest each year, you must continue to do so unless you get permission to change your method of reporting. If you have chosen to defer reporting the interest, you need not include the interest in income for the year of original maturity. Report it in the year you redeem the bonds or the year in which the extended maturity period ends, whichever is earlier. The original maturity period has been extended on all Series E Bonds.

Series E Bonds issued between May 1941 and April 1952 have a term of 40 years, and the Department of the Treasury has announced that no further extension will be given to those bonds. Therefore, if you have deferred reporting interest on Series E Bonds purchased in 1948, you must report the interest on your 1988 return, unless you trade your Series E Bonds for Series HH Bonds.

Co-owners. If you buy a U.S. Savings Bond issued in your name and another person's name as co-owners, such as you and your child or you and your spouse, interest on the bond is taxable to the co-owner who bought the bond. If you furnished the money to buy the bond, you must pay the tax on the interest. This is true even if you let the other co-owner redeem the bond and keep all the proceeds. Under these circumstances, since the other co-owner will receive a Form 1099–INT at the time of redemption, the other co-owner must provide you with another Form 1099–INT showing the amount of interest from the bond that is taxable to you. See *Nominee distributions and accrued interest,* later, under *How to Report Interest Income,* for more information about providing a Form 1099–INT to another person.

Ownership transferred. If you have Series EE or Series E Bonds bought entirely with **your own funds** reissued in your co-owner's name or beneficiary's name alone, you must include in your gross income for the year of reissue all interest that you earned on such bonds and have not previously reported. But, if the bond is reissued in your name alone, you do not have to report the interest accrued at that time. (This same rule applies when bonds are transferred between spouses or incident to divorce.)

If you buy Series EE or Series E Bonds **jointly** with a co-owner and have them reissued in the co-owner's name alone, you must include in your gross income for the year of reissue your share of all the interest earned on the bonds that you have not previously reported. At the time of reissue the former co-owner does not have to include in gross income his or her share of the interest earned that was not reported before the transfer. This interest, as well as all interest earned after the reissue, is income to the former co-owner.

This income reporting rule also applies when the bonds are reissued in the name of your former co-owner and a new co-owner, except that the new co-owner will report only his or her share of the interest earned after the transfer.

If bonds that you and a co-owner bought jointly are reissued to each of you separately in the same proportion as your contribution to the purchase price, neither you nor your co-owner has to report at that time the interest earned before the bonds were reissued.

Example. You and your spouse each spent an equal amount to buy a $1,000 Series EE Savings Bond. The bond was issued to you as co-owners. You both defer reporting interest on the bond. You later have the bond reissued as two $500 bonds, one in your name and one in your spouse's name. At that time neither you nor your spouse has to report the interest earned to the date of reissue. But if you bought the $1,000 bond entirely with your own funds, you must report half the interest earned to the date of reissue. This is the previously deferred interest earned on the $1,000 bond that is attributable to the $500 bond issued to your spouse.

Transfer to a trust. If you own Series EE or Series E Bonds and transfer them to a trust, giving up all rights of ownership, you must include in your income for that year the interest earned to the date of transfer, if you have not already reported it. However, if you are considered the owner of the trust and the increase in value both before and after the transfer continues to be taxable to you, you may continue to defer reporting the interest earned each year. You must include the total interest in your income when the bonds are cashed or finally mature, whichever is earlier.

The same rules apply to previously unreported interest on Series EE or Series E Bonds if the transfer to a trust consisted of Series HH or Series H Bonds you got in a trade for the Series EE or Series E Bonds. See *Savings bonds traded,* later.

Decedents. The manner of reporting interest income on Series EE or Series E Bonds, after death of the owner, depends on the accounting and income reporting method previously used by the decedent. If the bonds transferred because of death were owned by a person who used the accrual method, or who used the cash method and had chosen to report the interest each year, the interest earned in the year of death up to the date of death must be reported on that person's final return. The person who acquires the bonds includes in income only interest earned after the date of death.

If the bonds transferred because of death were owned by a person who used the cash method and had not chosen to report the interest each year, and who bought the bonds entirely with his or her own funds, all interest earned before death must be reported in one of the following ways:

1) The person (executor, administrator, etc.) who files the final income tax return of the decedent may choose to include in it all of the interest earned on the bonds before the decedent's death. The person who acquires the bonds then includes in income only interest earned after the date of death, or
2) If the choice in (1) is not made, the interest earned to the date of death is income in respect of a decedent. It should not be included in the decedent's final return. All of the interest earned both before and after the decedent's death is income to the person who acquires the bonds. If that person uses the cash method and does not choose to report the interest yearly, he or she may defer reporting any of it until the bonds are cashed or finally mature, whichever is earlier. In the year that person reports the interest, he or she may claim a deduction for any federal estate tax paid that was for the part of the interest included in the decedent's estate.

For more information on income in respect of a decedent, see Chapter 4.

Example 1. Your uncle, a cash method taxpayer, died and left you a $1,000 Series E Bond. He bought the bond for $750 and had not chosen to report the interest each year. At the date of death, interest of $200 had accrued on the bond and its value of $950 was included in your uncle's estate. Your uncle's executor did not choose to include the $200 accrued interest in your uncle's final income tax return.

You are a cash method taxpayer and do not choose to report the interest each year as it is earned. If you cash the bond when it reaches maturity value of $1,000, you report $250 interest income—the difference between maturity value of $1,000 and the original cost of $750. Also, you may deduct in that year any federal estate tax you paid (as a miscellaneous itemized deduction not subject to the 2% AGI limit) because the $200 interest was included in your uncle's estate.

Example 2. If, in Example 1, the executor had chosen to include the $200 accrued interest in your uncle's final return, you would report only $50 as interest when you cashed the bond at maturity. This $50 is the interest earned after your uncle's death.

Example 3. Your aunt died owning Series H Bonds that she got in a trade for Series E Bonds. (See *Savings bonds traded.*) You were the beneficiary of these bonds. Your aunt used the cash method and did not choose to report the interest on the Series E Bonds each year as it accrued. Your aunt's executor did not choose to include any interest earned before your aunt's death on her final return.

The income in respect of a decedent is the sum of the unreported interest on the Series E Bonds and the interest, if any, payable on the Series H Bonds but not received as of the date of your aunt's death. You must report any interest received during the year as income on your return. The part of the interest that was payable but not received before your aunt's death is income in respect of the decedent and may qualify for the estate tax deduction. For when to report the interest on the Series E Bonds traded, see *Savings bonds traded,* next.

Savings bonds traded. If you traded Series E Bonds for Series H Bonds, or Series EE or Series E Bonds for Series HH Bonds, you did not realize taxable income unless you received cash in the trade. Any cash you received is income to the extent of the interest earned on the bonds traded. When your Series HH or Series H Bonds mature, or if you dispose of them before maturity, you report as interest the difference between their redemption value and the sum of your cost of the traded Series EE or Series E Bonds plus any amount you had to pay at the time of the trade.

Example. You trade Series E Bonds with a redemption value of $2,723.35 for Series HH Bonds. You get $2,500 in Series HH Bonds and $223.35 in cash. You must report the $223.35 as taxable income in the year of the trade to the extent that it is unreported interest on the Series E Bonds you traded.

$500 minimum value. Series EE or Series E Bonds that you want to trade must have a current redemption value of $500 or more. To figure the current redemption value of the bonds to be traded, you must add the accrued interest to their original purchase price.

You may choose to treat all of the accrued interest on the Series EE or Series E Bonds traded for Series HH Bonds as income in the year of the trade.

Accrual method taxpayers. If you are an accrual method taxpayer, you must report interest on U.S. Savings Bonds each year as it accrues. You may not defer reporting interest until the bonds are cashed or mature.

Form 1099–INT for U.S. Savings Bonds interest. When you cash a bond, the bank or other payer that redeems it must give you a Form 1099–INT if the interest part of the payment you receive is $10 or more. Box 3 of your Form 1099–INT should show the interest as the difference between the amount you received and the amount paid for the bond. However, your Form 1099–INT may show more interest than you are required to include on your income tax return. For example, this may happen if:

1) You chose to report the increase in the redemption value of the bond each year. The interest shown on your Form 1099–INT will not be reduced by amounts previously included in income.
2) You received a bond from a decedent. The interest shown on your Form 1099–INT will not be reduced by any interest reported by the decedent before death, or on the decedent's final return, or by the estate on the estate's income tax return.
3) Ownership of a bond was transferred. The interest shown on your Form 1099–INT will not be reduced by interest that accrued prior to the transfer.
4) You redeemed a bond on which you were named as a co-owner but for which you did not furnish the money to buy the bond. (See *Co-owners*, earlier in this chapter, for more information about the reporting requirements.)
5) You received a taxable distribution of bonds from a retirement or profit-sharing plan. The interest shown on your Form 1099–INT will not be reduced by the interest portion of amounts taxable as a distribution from a retirement or profit-sharing plan and not taxable as interest. (These amounts are generally shown on Form 1099–R, *Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.*)

For information on including the correct amount of interest on your return for (1), (2), (3), and (4), above, see *How to Report Interest Income*, later. Publication 550 includes examples showing how to report these amounts.

If you received a taxable distribution of bonds from a retirement or profit-sharing plan ((5), above), see Publication 550 for information on how to report the interest.

Note: U.S. Savings Bond interest is exempt from state and local taxes. The Form 1099–INT you receive will indicate the amount that is for U.S. Savings Bond interest in Box 3. Do not include this amount on your state or local income tax return.

Caution: As this publication was being prepared for print, Congress was considering legislation that would exclude interest income earned on a qualified U.S. Savings Bond from gross income if the bond is transferred to an eligible educational institution as payment for the tuition and required fees of a taxpayer, or a taxpayer's spouse or dependents.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Bonds Sold Between Interest Dates

When bonds are sold between interest dates, part of the sales price is accrued interest. The seller must report this amount as taxable interest. The purchaser may treat this amount as a capital investment and deduct it from the next interest payment as a return of capital, but must report the total payment as taxable interest and show the accrued interest as an adjustment (or subtraction). See *How to Report Interest Income* for information about making this adjustment.

If the bond is an original issue discount debt instrument, see the discussion on original issue discount later to determine the original issue discount you must include in income. Also, see *Original issue discount (OID)*, under *How to Report Interest Income*, for information on how to report original issue discount on your income tax return.

If the bond has market discount, see the later discussion under ***Market discount bonds*** for information about the accrued market discount that must be recognized as interest income.

Insurance Received in Installments

If insurance proceeds are payable to you because of the death of your spouse (who died before October 23, 1986), and you get them in installments, you may exclude up to $1,000 a year of the interest included in the installments. This $1,000 interest exclusion is in addition to the part of each installment that you do not include in income because it is a recovery of the lump sum payable at death. (See *Life Insurance Proceeds* in Chapter 13.) If you later remarry, you may continue to take the $1,000 interest exclusion.

Example. Fern Green, a widow whose husband died in June 1986, chooses to receive the proceeds of her husband's $75,000 life insurance policy in ten yearly installments of $11,250. The payments are based on a guaranteed interest rate. She will include $2,750 in income each year. She figures this in the following way:

Fixed payment	$11,250
Minus: Amount of insurance principal ($75,000 ÷ 10)	7,500
Interest included in installment	$ 3,750
Minus: Annual $1,000 interest exclusion	1,000
Amount included in gross income	$ 2,750

Note. The $1,000 interest exclusion, described above, is ***not allowable*** with regard to amounts received by an individual whose spouse died after October 22, 1986.

If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income. See Publication 575, *Pension and Annuity Income.*

For more information about the tax treatment of insurance proceeds, see Publication 525, *Taxable and Nontaxable Income.*

Original Issue Discount (OID)

Original issue discount (OID) is generally includible in income. It is the difference between the principal amount (stated redemption price at maturity) of a long-term debt instrument, such as a bond, note, or other evidence of indebtedness, and its issue price. All long-term debt instruments that pay no interest prior to maturity are presumed to be issued at a discount. Zero-coupon bonds are one example of such instruments. (This treatment does not apply to short-term obligations, with a fixed maturity date of one year or less from date of issue, discussed later.)

You may disregard reporting the discount as income and treat it as zero if it is less than one-fourth of 1% (.25%) of the stated redemption price, multiplied by the number of full years from the date of original issue to maturity.

Example 1. You bought a 10–year bond, with a stated redemption price at maturity of $1,000, issued at $980 and having OID of $20. One-fourth of 1% of $1,000 (stated redemption price) times 10 (number of full years from the date of original issue to maturity) equals $25. Because the $20 discount is less than $25, you may disregard reporting the OID.

Example 2. Assume the same facts as in Example 1, except that the bond was issued at $950. The OID is $50. Because the $50 discount is more than the $25 figured in Example 1, you must report the OID.

Form 1099–OID. The issuer of the debt instrument (or your broker, if you purchased the instrument on a secondary market) should give you a copy of Form 1099–OID, *Statement for Recipients of Original Issue Discount*, or a similar statement, if the total OID for the calendar year is $10 or more and the term of the instrument is more than one year. Form 1099–OID shows the amount of OID. It also will show stated interest that you must include in your income. A copy of Form 1099–OID will be sent to the Internal Revenue Service. Do not file your copy with your return. Keep it for your records. If you are required to file a return, a negligence penalty (described earlier) will be imposed on you if this income is taxable and the IRS determines that it has not been reported. See *Recomputation of OID shown on Form 1099–OID*, later in this discussion and also *Original issue discount (OID)* under *How to Report Interest Income*, for more information.

If you had OID for 1988 but did not receive a Form 1099–OID, see Publication 1212, *List of Original Issue Discount Instruments.* Publication 1212 lists total OID on certain debt instruments and gives computational information. If your debt instrument is not listed in Publication 1212, consult the issuer for further information about the OID that accrued for 1988.

Nominee. If someone is the holder of record of an OID instrument that belongs to you and receives a Form 1099–OID on your behalf, that person must give you a Form 1099–OID. The form will show the OID for the entire year regardless of whether you owned or held the instrument for the entire year.

Debt instrument bought at premium. If you buy at a premium a debt instrument that was originally issued at a discount, you do not have to report any OID as ordinary income. "Premium" means a purchase price that exceeds the stated redemption price of the instrument at maturity. When you sell or redeem an instrument bought at a premium, the difference between the sale or redemption price and your purchase price is a capital gain or loss.

This rule, however, does not apply if you bought a debt instrument and paid an "acquisition premium." See *Acquisition premium*, later in this chapter, for more information about the treatment of this type of premium.

Exceptions to the OID rules. The income tax rules for reporting OID on publicly offered, long-term instruments, do not apply to the following debt instruments:

1) Tax-exempt obligations;
2) U.S. Savings Bonds;
3) Short-term debt instruments which have fixed maturity dates of not more than one year from the date of issue;
4) An obligation issued by an individual before March 2, 1984; and
5) Loans of $10,000 or less from individuals (when increased by the outstanding amount of prior loans by that individual to the other individual) who are not in the business of lending money. (This exception does not apply if a principal purpose of the loan is to avoid any federal tax.)

Debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument). For these instruments, you pay no tax on the OID until the year the instrument is sold, exchanged, or redeemed. If a gain results, and if the instrument is a capital asset, the amount of the gain equal to the OID is taxed as ordinary income. The balance of the gain is capital gain. If there is a loss on the sale of the instrument, the entire loss is a capital loss and no reporting of OID is required.

Corporate debt instruments issued after May 27, 1969, and before July 2, 1982. If you hold these debt instruments as capital assets, you must include a part of the discount in your gross income each year that you own the instruments. Your basis in the instrument is increased by the amount of OID that you include in your gross income.

If you bought the instruments ***at original issue*** and held them for all of 1988, or the part of 1988 that they were outstanding, include in your gross income the total OID from Form 1099–OID. If the instruments you bought at original issue were outstanding for all of 1988, but you did not hold them for the entire year, figure your taxable OID by dividing the total OID for 1988 by 12 and multiplying the result by the number of complete and partial ***months*** (for example, 6½ months) you held the instruments in 1988.

If you bought the instrument ***after its original issue,*** see *Recomputation of OID shown on Form 1099–OID*, later, for more information.

Debt instruments issued after July 1, 1982, and before January 1, 1985. If you hold these debt instruments as capital assets, you must include a part of the discount in your gross income each year and increase your basis by the amount included. You report the total OID from Form 1099–OID, if you bought the instruments at original issue and held them all of 1988 (or the part of 1988 that they were outstanding). If the instruments you bought at original issue were outstanding for all of 1988, but you did not hold them the entire year, figure your taxable OID by determining the ***daily*** portions of OID for each accrual period that occurs in 1988. An "accrual period" for any OID instrument issued before 1985 is each one-year period beginning on the date of issue of the instrument and each anniversary thereafter, or the shorter period to maturity for the last accrual period. See Publication 1212 for information about determining reportable OID.

If you did not acquire the debt instrument at its original issue, see *Recomputation of OID shown on Form 1099–OID*, later in this chapter, for more information.

Debt instruments issued after December 31, 1984. If you hold these debt instruments, the OID reporting rules, in general, are similar to those for debt instruments issued after July 1, 1982. However, you report the total applicable OID (based on the number of days in the accrual period) without regard to whether you hold that debt instrument as a capital asset. Your basis in the instrument is increased by the amount of OID that you include in your gross income. The method for determining the reportable discount on any OID instrument issued after 1984 is based on an accrual period of 6 months. For more information about determining reportable OID for these debt instruments, see Publication 1212.

Recomputation of OID shown on Form 1099–OID. If you bought a debt instrument ***at original issue*** and held it for all of 1988, or the part of 1988 that it was outstanding, include in your gross income the total OID and any other periodic interest shown in Box 1 and Box 2 of Form 1099–OID. However, because the amount of OID shown on Form 1099–OID is determined on the assumption that you purchased the related debt instrument at original issue and owned it for the entire calendar year (or every day of the calendar year that the instrument was outstanding), the amount of OID shown in Box 1 of Form 1099–OID may not be the correct amount for you to include in your income. You must recompute your correct share of the OID shown in Box 1 of Form 1099–OID if any of the following apply to your ownership or holding of a long-term OID debt instrument:

1) The corporate instrument bought by you at original issue was outstanding for all (or part) of 1988, but you did not hold it for the entire period it was outstanding in 1988, or
2) The corporate instrument was bought by you ***after its original issue,*** or
3) The debt instrument is a stripped bond or a stripped coupon (these include zero coupon U.S. Treasury-backed securities).

For each of these situations, see Publication 1212, which provides detailed information and examples about figuring the amount of OID to report on your income tax return. The rules for figuring OID are broken down in Publication 1212 to reflect the specific computations that apply to corporate long-term OID debt instruments issued before July 2, 1982, and to all long-term OID debt instruments issued after July 1, 1982.

Reporting correct amount of OID. If you are reporting OID in an amount greater or less than the amount shown on Form 1099–OID, see *Original issue discount (OID)* under *How to Report Interest Income*, later, for information about reporting the correct amount of OID on Schedule B (Form 1040).

Form 1099–OID not received. If you had OID for 1988 but did not receive a Form 1099–OID, see Publication 1212 which lists total OID on certain debt instruments. If your debt instrument is not listed in Publication 1212, consult the issuer for further information about the OID that accrued for 1988.

Acquisition premium. If you bought a debt instrument for more than the original issue price plus accumulated OID from the date of issue, that excess amount (or acquisition premium) reduces the amount of discount includible in your income. See Publication 1212 for information about figuring this reduction.

Recomputation of periodic interest shown on Form 1099–OID. If you disposed of a corporate debt instrument or acquired it from another holder during 1988, see *Bonds Sold Between Interest Dates*, earlier, for information about the treatment of periodic interest that may be shown in Box 2 of Form 1099–OID for that instrument. See *Nominee distributions and accrued interest* under *How to Report Interest Income*, later in this publication, for information about reporting the correct amount of interest on Schedule B (Form 1040).

Stripped bonds and stripped coupons. Special rules apply to the sale and purchase of stripped bonds and stripped coupons after July 1, 1982. These rules also cover the treatment of zero coupon U.S. Treasury-backed securities. See Publication 1212 for more information about how to treat stripped bonds and stripped coupons.

Certificates of deposit and similar deposit arrangements. If you make a deposit in any of these arrangements and the receipt of interest is deferred for more than one year, you must include in income a part of the total interest due you in the same way as other original issue discount (OID).

Examples of such deposit arrangements with banks, building and loan associations, etc., include:

Certificates of deposit
Time deposits
Bonus plans
Savings certificates
Deferred income certificates
Bonus savings certificates

Growth savings certificates

Interest subject to penalty for early withdrawal. If you deposit money in one of the arrangements described earlier that has a term of one year or less, and you cannot withdraw the interest without losing a large part of it, you include all the interest in income at the end of the term.

Example. On October 1, 1988, you invested $10,000 in a savings certificate that will pay you $10,600 on April 1, 1989. If you withdraw any part of the principal or interest before April 1, you will lose the first $300 of interest that you accrue. If you wait until April 1 to withdraw your investment, you will include the entire $600 in income for 1989.

Bearer certificates of deposit are not issued in the depositor's name and, therefore, are transferable from one individual to another. They are issued by banks for a deferred withdrawal period, usually a number of years. Interest is not usually paid until the certificates are redeemed by the bank at the end of this period.

Banks are required to provide the Internal Revenue Service and the person redeeming the bearer certificate with a Form 1099–INT.

Certificates of deposit issued after 1982, are generally required to be in registered form.

For more information about interest income from certificates of deposit, see Publication 550.

Market discount bonds. A market discount bond is any bond having market discount except:

1) Short-term obligations with fixed maturity dates of up to 6 months from the date of issue (up to one year from the date of issue for obligations acquired after 1988),
2) Tax-exempt obligations,
3) U.S. Savings Bonds, and
4) Certain installment obligations.

Market discount arises when the value of a debt obligation decreases after its issue date, generally because of an increase in interest rates. If you buy a bond on the secondary market, it may have market discount.

If you dispose of a market discount bond issued after July 18, 1984, you generally must recognize the gain as interest income to the extent of the bond's accrued market discount. For more information about the methods of figuring ***accrued market discount,*** see Publication 550.

Discount on short-term obligations. Certain holders of short-term obligations are required to accrue and include the discount on such obligations in current income. The amount of the acquisition discount (stated redemption price at maturity over your basis) that is includible in income for the tax year is determined under the same methods used to figure accrued market discount. See Publication 550 for more information.

REMIC regular interests. If you are the holder of a regular interest in a real estate mortgage investment conduit (REMIC), that interest is considered to be a discounted debt instrument for income tax purposes, whether or not your regular interest is in the form of a debt instrument. The rules for accruing and reporting OID, market discount, etc., apply to such REMIC regular interests. For more information, see Publication 550.

State or Local Government Obligations

Interest on obligations of a state or one of its political subdivisions, the District of Columbia, a possession of the United States, or one of its political subdivisions, is ***tax exempt.*** This includes interest on certain obligations issued after 1982 by Indian tribal governments recognized by the Secretary of the Treasury as having the right to exercise one or more sovereign powers.

If you receive a Form 1099–INT for interest paid on a tax-exempt obligation, see the specific reporting instructions discussed later in *Form 1040A,* or *Form 1040,* as applicable, under *How to Report Interest Income.*

Interest on arbitrage bonds issued by state or local governments after October 9, 1969, and interest on private activity bonds generally is ***taxable.***

For more information on whether such interest is taxable or tax exempt, see *State or Local Government Obligations* in Publication 550.

Information reporting requirement. If you received or accrued any tax-exempt interest income (such as interest on certain state and municipal bonds), you must show that interest on your tax return if you are required to file. This is an information reporting requirement and does ***not*** convert tax-exempt interest to taxable interest. See *How to Report Interest Income,* later.

When to Report Interest Income

When you report your interest income depends on whether you use the cash-basis method or the accrual-basis method of reporting income.

Cash basis. If you use this method, you report your interest income in the year in which you actually or constructively receive it. Most individual taxpayers use this method. However, there are special rules for OID and certain U.S. Savings Bonds. See *U.S. Savings Bonds* and *Original Issue Discount (OID),* earlier.

Example. On September 1, 1986, you loaned $2,000 at 12% a year. The note stated that principal and interest would be due on August 31, 1988. In 1988 you received $2,480 ($2,000 principal and $480 interest). If you use the cash-basis method, you must include in income on your 1988 return the $480 interest you received in 1988.

You constructively receive income when it is credited to your account or made available to you. You do not need to have physical possession of it. For example, you are considered to receive interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to your account and subject to your withdrawal. This is true even if they are not yet entered in your passbook.

You constructively receive income on the deposit or account even if you must:

1) Make withdrawals in multiples of even amounts,
2) Give a notice to withdraw before making the withdrawal,
3) Withdraw all or part of the account to withdraw the earnings, or
4) Pay a penalty on early withdrawals, unless the interest you are to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

You constructively receive interest when it is credited to your account under a long-term savings plan that does not let you withdraw interest until a specified date, if the plan lets you freely withdraw your deposits of principal.

Accrual basis. If you use this method, you report your interest income when you earn it, whether or not you have received it.

Example. If, in the above example, you use the accrual method, you must include the interest in your income as you earn it. You would report the interest as follows: 1986, $80; 1987, $240; and 1988, $160.

Coupon bonds. Interest on coupon bonds is taxable in the year the coupon becomes due and payable. It does not matter when you mail the coupon for payment.

Uniformed Services Savings Deposit Program. Because interest on this type of an account is subject to substantial restrictions on withdrawal if the account balance is less than $10,000, you do not include it in income until you actually receive it or it is made available to you. However, you must include in income interest that you may withdraw quarterly on an account that has reached and kept a balance of $10,000.

How to Report Interest Income

Generally you report all of your taxable interest income on line 8a, Form 1040; line 8a, Form 1040A; or on line 2, Form 1040EZ. However, you may not use Form 1040A or Form 1040EZ if you received interest as a nominee for someone else, or if you received or paid accrued interest on securities transferred between interest payment dates. If your interest income is more than $400, you may not use Form 1040EZ and you must complete the schedules for Form 1040A or Form 1040, as described later.

Form 1040A

If your taxable interest income totals more than $400, you must list each payer's name (include the name of any brokerage firm which gave you a Form 1099–INT or a Form 1099–OID) and the amount of interest income received from each payer in Part II of Schedule 1 (Form 1040A) and attach it to your return. However, you must use Form 1040 instead of Form 1040A if you received interest as a nominee for someone else, if you are reporting OID in an amount greater or less than the amount shown on Form 1099–OID, or if you received or paid accrued interest on securities transferred between interest payment dates.

Tax-exempt interest income. If you received any tax-exempt interest, such as from state or local government obligations, do not include this income on line 8a. Instead, enter your tax-exempt interest on line 8b. Also include on line 8b any exempt-interest dividends received from a mutual fund or other regulated investment company. If you are completing Part II of Schedule 1 (Form 1040A), include the tax-exempt interest on line 1, only if you received a Form 1099–INT for that interest. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, write "Tax-Exempt Interest" and show the amount of this interest. Subtract this amount from the subtotal and write the result on line 2 of Part II and on line 8a. Be sure to show the tax-exempt interest on line 8b.

Interest earned on an individual retirement arrangement is tax deferred rather than tax exempt. Do not include such amount in tax-exempt interest.

Frozen deposits. If you receive a Form 1099–INT for interest on deposits that you could not withdraw at the end of 1988, you may choose to exclude such amounts from your gross income, as explained earlier. If you make this choice, do not include this income on line 8a. If you are completing Part II of Schedule 1 (Form 1040A), include in line 1 the interest shown on Form 1099–INT. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, write "Frozen Deposits" and show the amount of interest that you are excluding. Subtract this amount from the subtotal and write the result on line 2 of Part II.

Form 1040

If your taxable interest income is more than $400 and you use Form 1040, you must attach a Schedule B to your return and list each payer's name and the amount received from each.

On line 1, Part I of Schedule B (Form 1040), report the interest part of any payment you receive from an individual on a seller-financed mortgage or other forms of seller financing resulting from the ***sale of your home*** or other property. List each payer's name and the amount of interest.

Report on line 2, Part I of Schedule B (Form 1040), all interest other than seller-financed mortgage interest. Include the total amount of interest income that is shown in Box 1 and Box 3 of any Form 1099–INT or in Box 1 and Box 2 of any Form 1099–OID that you receive for the tax year, and other interest income received for which you did not receive a Form 1099. List each payer's name (include the name of any brokerage firm which gave you a Form 1099–INT or a Form 1099–OID) and the amount of interest. If you had more than $400 of interest income, you must complete Part III of Schedule B (Form 1040). See *Foreign financial accounts and foreign trusts*, discussed earlier in Chapter 1.

Tax-exempt interest income. If you received any tax-exempt interest income (such as interest on certain state and municipal bonds), you must report the total amount of that interest on line 8b of Form 1040. Also report on line 8b any exempt-interest dividends that you received from a mutual fund or other regulated investment company. Do not include this interest in your total income on line 23. If you are completing Part I of Schedule B (Form 1040), report tax-exempt interest on line 2 only if you received a Form 1099–INT for that interest. Several lines above line 3, put a subtotal of all interest income listed on line 2. Below this subtotal, write "Tax-Exempt Interest" and show the amount of interest that you are excluding. Subtract this amount from the subtotal and enter the result on line 3. Be sure to also show this tax-exempt interest on Form 1040, line 8b.

Interest earned on an individual retirement arrangement (IRA) is tax deferred rather than tax exempt. Do not include such amount in tax-exempt interest.

Frozen deposits. If you receive a Form 1099–INT for interest on deposits that you could not withdraw at the end of 1988, you may choose to exclude such amounts from your gross income, as explained earlier. If you make this choice, do not include this income on line 8a. If you are completing Part I of Schedule B (Form 1040), include the full amount of interest shown on your Form 1099–INT on line 2, Part I of Schedule B (Form 1040). Several lines above line 3, put a subtotal of all interest income. Below this subtotal, write "Frozen Deposits" and show the amount of interest that you are excluding. Subtract this amount from the subtotal and write the result on line 3, Part I of Schedule B (Form 1040).

Nominee distributions and accrued interest. If the total interest income listed on line 2, Part I of Schedule B (Form 1040), includes any amount that you received as a nominee for the real owner or that reflects accrued interest paid on a bond that you bought between interest payment dates, show such an amount separately below a subtotal of all interest income listed. Identify the amount as "Nominee Distribution," or "Accrued Interest," as appropriate, and subtract it from the interest income subtotal. Report the result on line 3, Part I of Schedule B (Form 1040), and also on Form 1040, line 8a.

Interest on a joint account. If you receive a Form 1099–INT on which your federal identification number is shown, and 2 or more recipients are named or amounts belonging to another person are included, you must file a nominee form with the Internal Revenue Service to show the proper distributions of the amounts shown. Use another Form 1099–INT, complete a Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, and file both forms with the Internal Revenue Service Center. Give the other person Copy B of the Form 1099–INT which you filed as a nominee. On Form 1099–INT and Form 1096, you should be listed as the "Payer." On Form 1099–INT, the other owner should be listed as the "Recipient." You are not required, however, to file a nominee return to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see Publication 916, *Information Returns*, and the instructions for preparing Forms 1099.

Example. You receive a Form 1099–INT for 1988 that shows a total of $1,500 of interest income earned on a savings account that you hold jointly with your sister. You each have agreed to share the yearly interest income in proportion to the amount that each of you has invested, even though your identification (social security) number was submitted to the bank for its recordkeeping purposes. Your sister has deposited 30% of the amount invested in this account. As a result, you are considered to be a nominee on behalf of the amount of interest income belonging to your sister. For 1988, this amount is $450, or 30% of the total interest of $1,500.

You must provide your sister with another Form 1099–INT no later than January 31, 1989, showing $450 of interest income that she earned for 1988. You must also send a copy of the nominee Form 1099–INT, along with Form 1096, to the Internal Revenue Service Center no later than February 28, 1989. In this case, show your own name, address, and identification number as that of the "Payer" on the nominee Form 1099–INT. Provide the same information for your sister in the blocks provided for identification of the "Recipient."

When you prepare your own 1988 federal income tax return, report the total amount of interest income, $1,500, on line 2, Part I of Schedule B (Form 1040), and identify the name of the bank which paid this interest. Show the amount belonging to your sister, $450, as a subtraction from the subtotal of all interest on Schedule B and identify this subtraction as a "Nominee Distribution." Report the remaining balance of $1,050 on line 3, Part I of Schedule B (Form 1040), and on line 8a of Form 1040. (Your sister will report the $450 of interest income on her own tax return, if she is required to file a return, and identify you as the payer of that amount.)

Original issue discount (OID). If you are reporting original issue discount (OID) in an amount greater or less than the amount shown on Form 1099–OID, or other written statement (such as for a REMIC regular interest), include the full amount of OID shown on your Form 1099–OID or other statement on line 2, Part I of Schedule B (Form 1040). If the OID to be reported is less than the amount shown on Form 1099–OID, follow the above reporting rules for nominee distributions or accrued interest, as applicable, so that you will report only the OID you are required to report. Below the subtotal, write "OID Adjustment" and show the OID you are not required to report. If the OID to be reported is greater than the amount shown on Form 1099–OID, show the additional OID separately below a subtotal of all interest income listed. Identify the amount as "OID Adjustment" and add it to the interest income subtotal.

Market discount. Report as interest on line 8a of Form 1040 any gain on the sale (or other disposition) of certain market discount bonds, to the extent of the accrued market discount.

Interest from U.S. Savings Bonds. If you received a Form 1099–INT for U.S. Savings Bond interest, the form may show interest you are not required to report. See *Form 1099–INT for U.S. Savings Bonds interest*, earlier, under *U.S. Savings Bonds*.

You should show on line 2, Part I of Schedule B (Form 1040), or on line 1, Part II of Schedule 1 (Form 1040A), all the interest shown on your Form 1099–INT. On Schedule B, several lines above line 3, enter a subtotal of all interest listed on line 2. If you use Form 1040A, enter this subtotal several lines above line 2, Part II of Schedule 1. Below the subtotal write "U.S. Savings Bond Interest Previously Reported" and enter amounts previously reported or interest accrued prior to receiving the bond. (To figure the amount to enter for interest reported or being reported as a taxable distribution from a retirement or profit-sharing plan, see Publication 550.) Subtract these amounts from the subtotal and enter the result on line 3 of Schedule B (Form 1040) or on line 2, Part II of Schedule 1 (Form 1040A).

Penalty on early withdrawal of savings. If you withdrew funds from a time savings account before maturity, you may be charged a penalty. You must report on line 8a, Form 1040, the gross amount of interest paid or credited to your account during the year without subtracting the penalty. You deduct the penalty on line 28, Form 1040. Deduct the entire penalty even if it exceeds your interest income. The Form 1099–INT given to you by the financial institution will show the gross amount of interest and the penalty.

Form 1099–INT. To determine your total taxable interest income, add the amounts shown in Boxes 1 of your 1099–INTs, to any other taxable interest income you received. Report your total taxable interest income on your Form 1040EZ line 2, or on your Form 1040A line 8a, or on your Form 1040 line 8a.

If the total of your taxable interest income is more than $400, you must file either Form 1040A or Form 1040, and you must list the payers and the amounts you received from each payer on Form 1040A, Schedule 1, Part II or on Form 1040, Schedule B, Part I, and carry the total to line 8A.

If you had any tax-exempt interest income, or exempt-interest dividends from a mutual fund, you should report the total of this tax-exempt income on line 8b of Form 1040A or Form 1040; or write "TEI" in the space to the left of line 2 on Form 1040EZ. After "TEI," show the amount of your tax-exempt interest, but do not add tax-exempt interest in the total on Form 1040EZ line 2.

If you forfeited interest income because of the early withdrawal of a time deposit, the deductible amount will be shown on Form 1099–INT, in Box 2, (early withdrawal penalty). If an amount appears in Box 2, you should file Form 1040, and report this amount on Form 1040, line 28 (penalty on early withdrawal of savings).

Box 3 of Form 1099–INT shows the amount of interest income you received from U.S. Savings Bonds, Treasury bills, Treasury notes, and Treasury bonds. Include the amount shown in Box 3 in your total taxable interest income, unless it includes an amount previously included in interest income. If part of the amount shown in Box 3 was previously included in interest income, see *Interest from U.S. Savings Bonds* earlier.

If you were subject to backup withholding, because for example, you did not furnish your social security number to a payer, an amount will appear in Box 4 of 1099–INT (federal income tax withheld). Report the amount from Box 4, 1099–INT on Form 1040A, line 23a, or on Form 1040, line 54 (federal income tax withheld).

If there are entries in Boxes 5 and 6 of Form 1099–INT, you should file Form 1040, and report the amount shown in Box 5 (foreign tax paid) on Form 1116 (*Computation of Foreign Tax Credit*) unless the country shown in Box 6 is one for which a foreign tax credit may not be claimed, such as South Africa.

The sample return in Chapter 37 has an example on reporting interest income on Form 1040A. The sample return in Chapter 38 has an example on reporting interest income on Form 1040.

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9. Dividends and Other Corporate Distributions

Important Change for 1988

Reporting capital gain distributions. Capital gains are taxable in full at the same rate as your ordinary income.

Dividends are distributions of money, stock, or other property paid to you by a corporation. You also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts you receive that are called dividends are actually interest income. See *Dividends that are actually interest* in Chapter 8.

You may receive any of the following kinds of distributions:

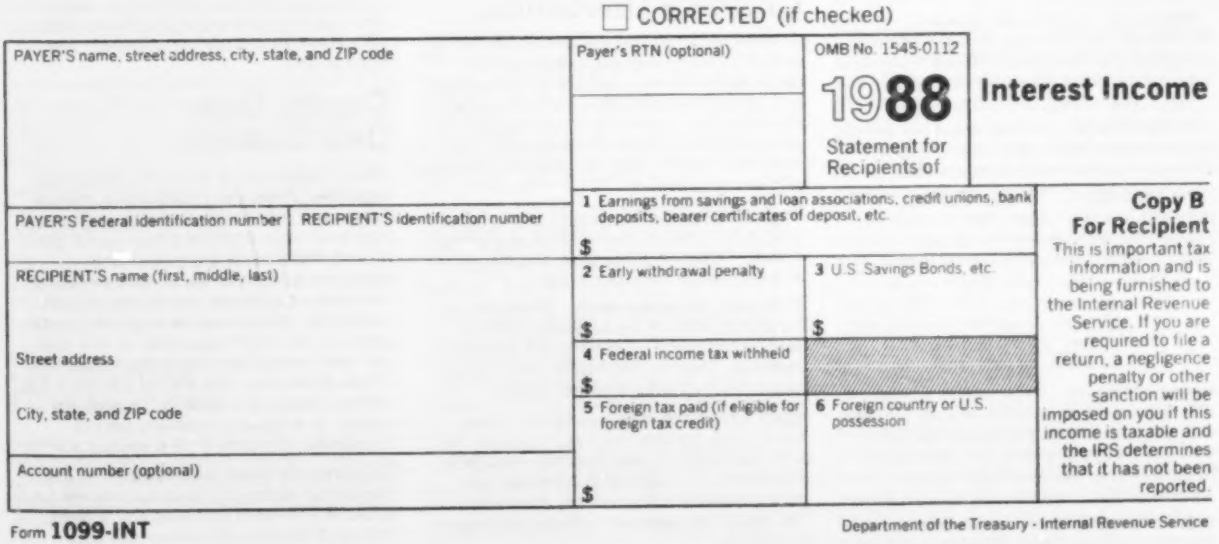
- Ordinary dividends
- Capital gain distributions
- Nontaxable distributions

Most distributions that you receive are paid in cash (check). However, you may receive additional stock, stock rights, other property, or services.

Passive activity income and losses. There are tax rules which limit the amount of losses and tax credits you may claim when such losses and credits are derived from passive activities. Generally, only income from passive activities can be used to offset losses from passive activities. Consequently, you generally cannot use passive activity losses to offset your other income, such as your wages or your ***portfolio income*** (that is, any gross income from interest, dividends, etc., that is not derived in the ordinary course of a trade or business). For more information about determining and reporting income and losses from passive activities, see Publication 925, *Passive Activity and At-Risk Rules.*

Tax on investment income of a child under age 14. If a child is under age 14 at the end of the year and has more than $1,000 of investment income (such as taxable interest and dividends), part of his or her investment income may be taxed at the parents' tax rate if either parent is alive at the end of the year. If these requirements are met, Form 8615, *Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000,* must be completed and attached to the child's tax return. If these requirements are not met, Form 8615 is not required and the child's tax is figured on his or her own tax rate.

The information contained in this chapter about dividend income applies generally to all



☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code

Payer's RTN (optional)

OMB No. 1545-0112

1988

Statement for Recipients of

Interest Income

PAYER'S Federal identification number

RECIPIENT'S identification number

1 Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc.
$

Copy B
For Recipient

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.

RECIPIENT'S name (first, middle, last)

2 Early withdrawal penalty
$

3 U.S. Savings Bonds, etc.
$

Street address

4 Federal income tax withheld
$

City, state, and ZIP code

5 Foreign tax paid (if eligible for foreign tax credit)
$

6 Foreign country or U.S. possession

Account number (optional)

Form **1099-INT**

Department of the Treasury - Internal Revenue Service taxpayers, including children. For more information about the tax on investment income of certain children, however, see Chapter 32.

Beneficiary of an estate or trust. Interest, dividends, or other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.—1988*, from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the items from Schedule K-1 on your Form 1040.

Backup withholding. To ensure that income tax is collected on dividends and other types of income that generally are not subject to withholding, "backup" withholding will apply in certain circumstances.

Under backup withholding, when you open a new account you must certify under penalties of perjury that your social security number is correct and that you are not subject to backup withholding. If you fail to make this certification, backup withholding may begin immediately on your new account or investment and 20% of the amount paid on your account or investment will be withheld. Your payer will give you a Form W-9, *Request for Taxpayer Identification Number and Certification*, or a similar form, to make this certification. Backup withholding may also be required if the Internal Revenue Service has determined that you underreported your interest and dividend income. For more information, see *Backup Withholding* in Chapter 5.

Form 1099–DIV. Most corporations use Form 1099–DIV, *Statement for Recipients of Dividends and Distributions*, or a similar statement, to show you the distributions you received from the corporation during the year. Keep this form with your records. You do not have to attach it to your tax return. Even if you do not receive Form 1099–DIV, you must report all of your taxable dividend income.

Reporting tax withheld. If tax is withheld from your dividend income, the payer must give you a Form 1099–DIV that indicates the amount withheld.

Nominees. If someone receives distributions as a nominee for you, that person will give you a Form 1099–DIV, which will show distributions they received on your behalf.

If you receive a Form 1099–DIV that includes amounts belonging to another person, see *Nominees*, later, under *How to Report Dividend Income*, for more information.

Form 1099–MISC. Certain substitute payments in lieu of dividends or tax-exempt interest that are received by a broker in your behalf must be reported to you on Form 1099–MISC, *Statement for Recipients of Miscellaneous Income*, or a similar statement. See Publication 550, *Investment Income and Expenses*, for more information about reporting such substitute payments.

Incorrect amount. If you receive a Form 1099 that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The corrected Form 1099 you receive will be marked "CORRECTED."

Negligence penalty on unreported dividend income. If you are required to file a return and you receive Forms 1099 showing taxable amounts of income, such as dividend payments, you must report these payments on your return. Failure to report any part of the payments will be treated as due to negligence in the absence of clear and convincing evidence to the contrary. Any additional tax due on this return will be subject to the 5% negligence penalty. The negligence penalty is applied to the entire amount of any underpayment of tax and not just to the part of the underpayment resulting from negligence. In addition, you will be subject to a related interest penalty equal to 50% of the interest due on the additional tax that is attributable to negligence.

Caution: As this publication was being prepared for print, Congress was considering legislation that would repeal the penalty of 50% of the interest on the underpayment due to negligence or fraud. Instead, it would make interest on the negligence and fraud penalties payable beginning on the last day for filing the return.

It would also restrict the negligence penalty, in cases of failure to include amounts shown on an information return, to the portion of the underpayment of tax due to such failure to report.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Social security number. You must give your name and social security number to the payer of dividends. If you are married and the funds in a joint account belong to you, you should give your social security number to the payer of the dividends. If the funds in the account are mixed, you may give either your number or your spouse's number, so long as the number you provide corresponds with the name listed on the account. You must give the payer the correct social security number if the number being used is wrong.

If you do not give your social security number to the payer of dividends, you may have to pay a penalty. See *Penalty for failure to supply social security number* under *Penalties* in Chapter 1. Backup withholding also may apply. See Chapter 5.

Ordinary Dividends

Ordinary dividends (taxable dividends) are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to you. Any dividend you receive, whether on common or preferred stock, is an ordinary dividend unless the paying corporation tells you otherwise.

Money market funds. Report amounts you receive from money market funds as dividend income. These amounts, generally, are paid as dividends rather than as interest.

Dividends on capital stock. Dividends on the capital stock of organizations, such as savings and loan associations, are ordinary dividends. They are not interest. You should report them with your dividend income.

Stock certificate in two or more names. If two or more persons, such as a husband and wife, hold stock as ***joint tenants, tenants by the entirety, or tenants in common,*** each person receives a share of any dividends from the stock. Each person's share is determined by local law.

Dividends used to buy more stock. The corporation in which you own stock may have a ***dividend reinvestment plan.*** This plan lets you choose to use your dividends to buy more shares of stock in the corporation instead of receiving the dividends in cash. If you are a member of this type of plan, other than certain public utility stock reinvestment plans, and you buy the stock at a price equal to the fair market value of the stock, you must report the cash dividends as income.

If you are a member of a dividend reinvestment plan that lets you buy the stock at a price less than the fair market value of the stock, you must report as income the fair market value of the stock on the dividend payment date. You also must report as income any service charge subtracted from your cash dividends before the dividends are used to buy the stock. But, you may be able to deduct this amount. See Chapter 30 for more information about deducting expenses of producing income.

In some dividend reinvestment plans, you can invest additional cash to buy shares of stock at a price less than fair market value. If you choose to do this, you must report as income the difference between the cash you invest and the fair market value of the stock you buy. When figuring this income amount, use the fair market value of the stock on the dividend payment date.

Public utility stock reinvestment plans. If you own stock in a qualified domestic public utility and chose to receive your dividends in common stock, rather than in cash, you must include in your gross income the total value of such stock dividends distributed after 1985.

Pre-1986 stock dividend exclusion. A stock dividend exclusion for reinvestment in public utility stock was allowable for distributions of such stock dividends (in lieu of cash dividends) that were made after 1981 and before 1986.

If you chose to exclude the value of the stock dividend from income, before 1986, you were required to exclude it on your return for the year in which you would have included the dividends in income. If you decide to change your choice, you may do so only with the permission of the Internal Revenue Service.

If you excluded from income the value of stock you received under a qualified public utility reinvestment plan, your basis in that stock is zero.

Capital Gain Distributions

These distributions or dividends are paid by ***regulated investment companies, mutual funds, and real estate investment trusts*** from their net realized long-term capital gains. A Form 1099–DIV or the mutual fund statement will tell you the amount you are to report as a capital gain distribution. Report capital gain distributions as long-term capital gains on your return regardless of how long you have owned the stock in the mutual fund. Those distributions that are not derived in the ordinary course of a trade or business are treated as portfolio income and are not considered as income from a passive activity.

Dividends declared in December. If the regulated investment company or mutual fund declares a dividend (including any exempt-interest dividend) in December and that dividend is payable to you on a specified date in that month, you are considered to have received the dividend on that specified date even though you receive it after December.

This treatment, however, only applies if the company actually pays the dividend before February 1 of the following calendar year.

Caution: As this publication was being prepared for print, Congress was considering legislation that would require you to treat certain dividends not paid until January 1989, as having been paid on December 31, 1988. Those dividends actually paid during January 1989 deemed to have been paid and received on December 31, 1988, would be those declared and made payable to shareholders of record in October, November, or December, 1988, by a regulated investment company (RIC) or by a real estate investment trust (REIT).

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Undistributed capital gains. Some mutual funds keep their long-term capital gains and pay taxes on those amounts. You must report as long-term capital gains any amounts that the mutual fund allocated to you as capital gain distributions, even though you did not actually receive them. (This income is not reported to you on Form 1099–DIV.)

If the investment company or mutual fund has paid a tax on the capital gain, you are allowed a credit for the tax, since it is considered paid by you. The company or fund will send you Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains,* showing the amount of the undistributed long-term capital gain and the tax paid. Take this credit by entering the amount of tax shown on Form 2439 on line 60, Form 1040. Attach Copy B of Form 2439 to your return.

Increase your basis in the stock by the difference between the amount of undistributed capital gain that you report and the amount of the tax paid for you by the fund. Keep Copy C of Form 2439 as part of your records to show increases in the basis of your stock.

Note: The undistributed long-term gain reported on Form 2439 should be reported in addition to any capital gain distributions reported on Form 1099–DIV.

Real estate investment trusts. (REITs) You will receive a Form 1099–DIV or similar statement from the real estate investment trust showing the capital gain distributions you must include in your income. You report the capital gain distributions as long-term capital gain regardless of how long you owned stock in the real estate investment trust.

For more information on the treatment of distributions from mutual funds and regulated investment companies, see Publication 564, *Mutual Fund Distributions.*

Nontaxable Distributions

You may receive a return of capital or a tax-free distribution of additional shares of stock or stock rights. These distributions are not treated the same as ordinary dividends or capital gain distributions.

Return of Capital

A return of capital is a distribution that is not paid out of the earnings and profits of a corporation. It is a return of your investment in the stock of the company. You should receive a Form 1099–DIV from the corporation showing you what part of the distribution is a return of capital.

A return of capital reduces the basis of your stock and is not taxed until your basis in the stock is fully recovered. When the basis of your stock has been reduced to zero, report any return of capital that you receive as a capital gain. Whether you report it as a long-term capital gain or short-term capital gain depends on how long you have held the stock. See *Holding Period* in Chapter 16.

Example. You bought stock in Corporation A in 1984 for $100. In 1986 you received a return of capital of $80. You did not include this amount in your income, but you reduced the basis of the stock. Your stock now has an adjusted basis of $20. You receive a return of capital of $30 in 1988. You use $20 of this amount to reduce your basis to zero. You report the other $10 as a long-term capital gain for 1988. You must report as a long-term capital gain any return of capital you receive on this stock in later years.

Liquidating distributions. Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive Form 1099–DIV from the corporation showing you the amount of the liquidating distribution.

Any liquidating distribution you receive is not taxable to you until you have recovered the basis of your stock. After the basis of your stock has been reduced to zero, you must report the liquidating distribution as a capital gain (except in certain instances with regard to collapsible corporations). Whether you report the gain as a long-term capital gain or short-term capital gain depends on how long you have held the stock. See *Holding Period* in Chapter 16.

If you acquired stock in a corporation at several different times, you own more than one block of stock in the corporation. If you receive distributions from the corporation in complete liquidation, you must divide the distribution among the blocks of stock you own in the same proportion as the number of shares in that block is to the total number of shares you own. Divide distributions in partial liquidation among that part of the stock that is redeemed in the partial liquidation. After the basis of a block of stock is reduced to zero, you must report the part of any later distribution for that block as a capital gain.

If the total liquidating distributions you receive are less than the basis of your stock, you may have a capital loss. You may report a capital loss only after you have received the final distribution in liquidation that results in the redemption or cancellation of the stock. Whether you report the loss as a long-term or short-term capital loss depends on how long you held the stock.

Distributions of Stock and Stock Rights

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights are distributions by a corporation of rights to subscribe to the corporation's stock. Generally, stock dividends and stock rights are not taxable to you and you do not report them on your return.

Taxable stock dividends and stock rights. Distributions of stock dividends and stock rights are taxable to you if:

1) You or any other shareholder has the choice to receive cash or other property instead of stock or stock rights,
2) The distribution gives cash or other property to some shareholders and an increase to you in your percentage interest in the corporation's assets or earnings and profits,
3) The distribution is in convertible preferred stock and has the same result as in (2),
4) The distribution gives preferred stock to some common stock shareholders and common stock to other common stock shareholders, or
5) The distribution is on preferred stock. (This requirement, however, does not apply if the distribution is made for convertible preferred stock solely to take into account a stock dividend, stock split, or a similar event that would otherwise result in reducing the conversion right.)

In addition, any transaction having the effect of increasing your proportionate interest in the corporation's assets or earnings and profits may be taxable to you even though no stock or stock rights are actually distributed.

Basis. If you receive stock dividends or stock rights that are taxable to you, your basis for the stock dividends or stock rights is their fair market value at the time of the distribution. If you receive stock dividends or stock rights that are not taxable to you, see Publication 550 for information on how to figure the basis of the stock dividends or stock rights you receive.

Fractional shares. You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which no fractional shares are issued, but all fractional shares are sold, and the cash proceeds given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. You must determine your gain or loss and report it as a capital gain or loss on Schedule D (Form 1040). Your gain or loss is the difference between the cash you receive and the basis of the fractional shares sold.

Example. You own one share of common stock that you bought on January 3, 1987, for $100. The corporation declared a common stock dividend of 5% on July 16, 1988. The fair market value of your stock at the time the stock dividend was declared was $200. You were paid $10 for the fractional-share stock dividend under a plan described in the above paragraph. You figure your gain or loss as follows:

Fair market value of old stock	$200.00
Fair market value of stock dividend (cash received)	10.00
Fair market value of old stock and stock dividend	$210.00
Basis (cost) of old stock after the stock dividend ($200 ÷ $210 × $100)	$ 95.24
Basis (cost) of stock dividend ($10 ÷ $210 × $100)	4.76
Total	$100.00
Cash received	$ 10.00
Basis (cost) of stock dividend	4.76
Gain	$ 5.24

Because you had held the share of stock more than 6 months (acquired before 1988) at the time the stock dividend was declared, your gain on the stock dividend is a long-term capital gain.

Other Distributions

You may receive any of the following distributions during the year.

Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information reporting requirements*, next.) You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends you received. See also *Dividends declared in December*, earlier, under *Capital Gain Distributions*. Exempt-interest dividends are not shown on Form 1099–DIV or Form 1099–INT. See Publication 564 for information about the loss treatment of mutual fund stock on which you received exempt-interest dividends.

Information reporting requirement. Although these dividends are not taxable, you must show them on your tax return if you are required to file a return. This is an information reporting requirement and does ***not*** convert tax-exempt interest to taxable interest. See *How to Report Interest Income*, earlier, in Chapter 8.

Also, tax-exempt interest from private activity bonds generally is a "tax preference item" and may be subject to the alternative minimum tax. See Chapter 31 for more information.

Dividends on insurance policies are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract. However, you must report as taxable income interest paid or credited on dividends left with an insurance company. See Chapter 8 for treatment of interest income.

Dividends on veterans' insurance are not taxable. However, you must report as taxable income interest on dividends left with the Veterans Administration. See Chapter 6 for more information about veterans' benefits.

Patronage dividends. Patronage dividends you receive in money from a cooperative organization are often included in your income.

Do not include in your income patronage dividends you receive on:

1) Property bought for your personal use, or
2) Capital assets or depreciable property bought for use in your business. However, you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

How to Report Dividend Income

Generally you may use either Form 1040 or Form 1040A to report your dividend income. However, you must use Form 1040 if you receive capital gain distributions or return of capital distributions, or receive dividends as a nominee for someone else. If you receive any dividend income, you may not use Form 1040EZ.

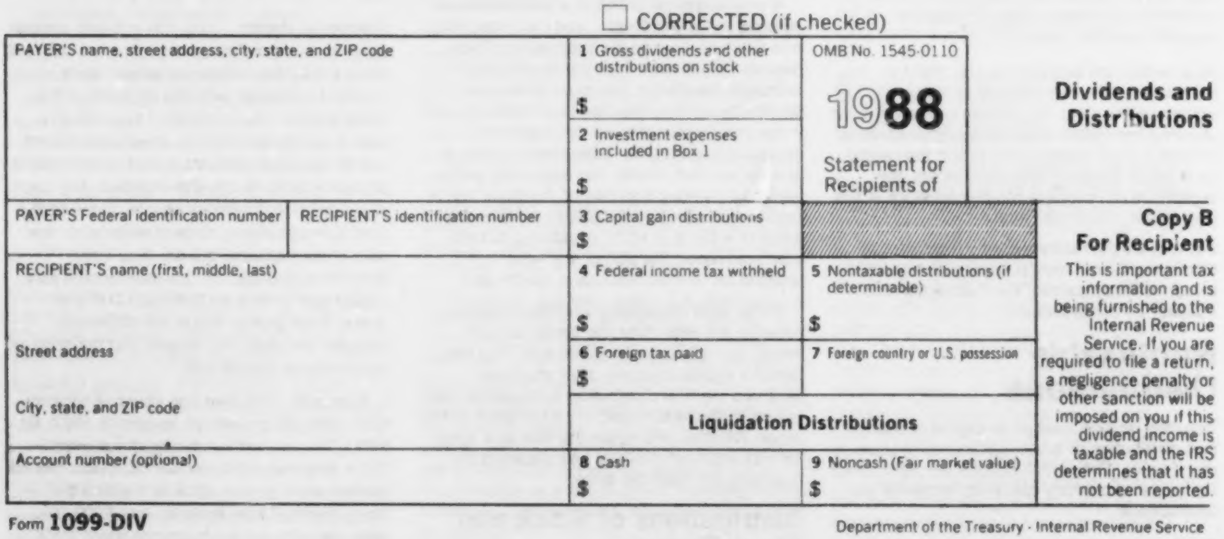
Form 1099–DIV. If you owned stock on which you received more than $10 gross dividends and other distributions, you should receive a Form 1099–DIV.

Box 1 of Form 1099–DIV shows the amount of gross dividends and other distributions you received on stock. If you received more than $400, list the payers and the amount of gross dividends received from each payer on either Form 1040A, Schedule 1, Part III, and enter the sum from Part III, line 2 on Form 1040A, line 9, or list them on Form 1040, Schedule B, Part II, and enter the result from Part II, line 9 on Form 1040, line 9.

Box 2 of Form 1099–DIV shows your pro rata share of certain amounts deductible by a regulated investment company. This amount is your share of the mutual fund's allocable investment expenses, and it is deductible by you as a miscellaneous itemized deduction subject to the 2% of adjusted gross income reduction on Form 1040, Schedule A. However, legislation pending in Congress may change this. See Chapter 30.

The amount of any capital gain distribution is shown in Box 3 of Form 1099–DIV. You report these capital gains on Form 1040, Schedule B, line 6. Since these capital gains are included in the amount shown in Box 1 of Form 1099–DIV, they are subtracted out on Form 1040, Schedule B, lines 6 and 8. These capital gains are also reported on either Form 1040, Schedule D, Part II, line 13 or, if you do not need to complete Schedule D, report them directly on Form 1040, line 14.

If you were subject to backup withholding, because for example you failed to furnish your social security number to a payer, the amount withheld will be shown in Box 4 of Form 1099–DIV. Report this amount on Form 1040A, line 23a, or on Form 1040, line 54.



☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code		1 Gross dividends and other distributions on stock $	OMB No. 1545-0110 1988 Statement for Recipients of	**Dividends and Distributions**
		2 Investment expenses included in Box 1 $		
PAYER'S Federal identification number	RECIPIENT'S identification number	3 Capital gain distributions $	▨	**Copy B For Recipient** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this dividend income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S name (first, middle, last)		4 Federal income tax withheld $	5 Nontaxable distributions (if determinable) $	
Street address		6 Foreign tax paid $	7 Foreign country or U.S. possession	
City, state, and ZIP code		**Liquidation Distributions**		
Account number (optional)		8 Cash $	9 Noncash (Fair market value) $	

Form **1099-DIV**

Department of the Treasury · Internal Revenue Service

The amount of any nontaxable distributions appears in Box 5, Form 1099–DIV. Since this amount is included in the amount shown in Box 1, Form 1099–DIV, it is subtracted out on Form 1040, Schedule B, lines 7 and 8.

Box 6 of Form 1099–DIV shows the amount of foreign taxes withheld (paid) on dividends and other distributions, and Box 7 identifies the foreign country that did the withholding. If there are entries in these Boxes, fill out Form 1040 and, Form 1116, *Computation of Foreign Tax Credit*, unless the taxes are paid to a nonqualifying country such as South Africa.

Distributions of cash from corporations in partial or complete liquidation are stated in Box 8 of Form 1099–DIV, and the fair market value of noncash distributions is stated in Box 9. If there are entries in these Boxes, see *Liquidating distributions* under *Dividends and Other Corporate Distributions* in Publication 550.

Form 1040A

Report your total dividends on line 9, Form 1040A. If the amount on line 9 is more than $400, you also must list each payer's name (include the name of any brokerage firm which gave you a Form 1099–DIV) and the amount of dividends received from each payer in Part III of Schedule 1 (Form 1040A) and attach it to your Form 1040A. However, you must use Form 1040 instead of Form 1040A if you had capital gain distributions or return of capital distributions, or received dividends as a nominee for someone else. (Exempt-interest dividends should be reported on line 8b. See Chapter 8.)

Form 1040—Total dividends and other distributions $400 or less.

If your total dividends, including capital gain and nontaxable distributions, are $400 or less, report only the total of your ordinary dividends from Box 1 of Form 1099–DIV on line 9, Form 1040.

Capital gain distributions. Report capital gain distributions on line 13, Part II of Schedule D (Form 1040). If you do not need Schedule D to report any other capital gains or losses, enter your capital gain distributions for 1988 on line 14, Form 1040.

Nontaxable (return of capital) distributions. Some distributions are nontaxable because they are a return of your cost. You report return of capital distributions as capital gain only when your basis in the stock has been reduced to zero. You report any return of capital distributions you receive after the basis of your stock has been reduced to zero on line 2c, Part I of Schedule D, if you held the stock one year or less (6 months or less if acquired before 1988), or on line 9c, Part II of Schedule D, if you held the stock for more than one year (more than 6 months if acquired before 1988).

Form 1040—Total dividends and other distributions more than $400.

If your total dividends, including capital gain and nontaxable distributions, are more than $400, you must fill in Schedule B and attach it to your return.

You must report all of your dividend income on line 4, Part II of Schedule B. You must include on this line all the ordinary dividends, capital gain distributions, and return of capital distributions you receive. You should list the name of the payer and the amount of income for each distribution you receive. If your securities are held by a brokerage firm (in "street name"), list the name of the brokerage firm that is shown on Form 1099–DIV as the payer. If your stock is held by a nominee who is the owner of record, and the nominee credits or pays you dividends on the stock, you should show the name of the nominee and the dividends you received or for which you were credited. You should enter on line 5 the total of the amounts listed on line 4. However, if you hold stock as a nominee, see *Nominees*, later.

Capital gain distributions. You enter on line 6, Part II of Schedule B, any amount shown on line 4 that is a capital gain distribution. You also enter this amount on line 13, Part II of Schedule D (Form 1040). If you do not need to use Schedule D to report any other gains or losses, do not use it. Instead, show your capital gain distributions on line 14, Form 1040.

Nontaxable (return of capital) distributions. You enter on line 7, Part II of Schedule B, any amount from line 4 that you received as a return of capital distribution. However, after the basis of your stock has been reduced to zero, you must also show this amount on line 2c, Part I of Schedule D, if you held the stock one year or less (6 months or less if acquired before 1988), or on line 9c, Part II of Schedule D, if you held the stock for more than one year (more than 6 months if acquired before 1988).

Completing Schedule B. Add the amounts shown on lines 6 and 7 and enter the total on line 8. Subtract line 8 from line 5. The difference, if any, is your taxable ordinary dividends. Enter this amount on line 9, Part II of Schedule B, and on line 9, Form 1040. If you had more than $400 of dividend income, you must complete Part III of Schedule B. See *Foreign financial accounts and foreign trusts* in Chapter 1 for more information.

Nominees. If you hold stock as a nominee and you distributed to others some, or all, of the dividends you received, list on line 4, Part II of Schedule B (Form 1040), all the dividends you received. Enter a subtotal of all your dividend income listed on line 4 several lines above line 5. Below the subtotal, write "Nominee Distribution" and enter the amounts you distributed. Subtract these distributions from the subtotal and enter the result on line 5.

If you receive a Form 1099–DIV, on which your federal identification number is shown, and 2 or more recipients are named or amounts belonging to another person are included, you must file a nominee form with the Internal Revenue Service to show the proper distributions of the amounts shown. Use another Form 1099–DIV, complete a Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, and file both forms with the Internal Revenue Service Center. Give the other person Copy B of the Form 1099–DIV which you filed as a nominee. On Form 1099–DIV and Form 1096, you should be listed as the "Payer." On Form 1099–DIV, the other owner should be listed as the "Recipient." You are not required, however, to file a nominee return to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see Publication 916, *Information Returns*, and the instructions for preparing Forms 1099.

Dividends on restricted stock. Restricted stock is stock you get from your employer for services you perform that is nontransferable and subject to a substantial risk of forfeiture. You do not have to include the value of the stock in your income when you receive it. However, if you get dividends on restricted stock, you must include them in your income as wages, not dividends.

Your employer should include these dividends in the wages shown on your Form W-2. If you also get a Form 1099–DIV for these dividends, list them on line 4, Part II of Schedule B (Form 1040), with the other dividends you received. Enter a subtotal of all your dividend income listed on line 4 several lines above line 5. Below the subtotal, write "Dividends on restricted stock reported as wages on line 7, Form 1040," and enter the amount of the dividends included in your wages on line 7, Form 1040. Subtract this amount from the subtotal and enter the result on line 5, Part II of Schedule B.

Restricted stock. You can choose to include in gross income the value of restricted stock as compensation for services. If you make this choice, the dividends are treated as any other dividends.

If you receive both a Form 1099–DIV and a Form W-2 showing these dividends, do not include the dividends in your wages reported on line 7, Form 1040. List the dividends on line 4, Part II of Schedule B, along with your other dividends. Attach a statement to your Form 1040 explaining why the amount shown on line 7 of your Form 1040 is different from the amount shown on your Form W-2.

Dividends on stock sold. If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee of the dividend check) must report the dividend. Even if the purchase price of the stock goes up because of the amount of the anticipated dividend, the owner of record must report such dividend.

Liquidating distributions. You will receive Form 1099–DIV from the corporation showing the amount of the liquidating distribution. After the basis of your stock has been reduced to zero, you report the liquidating distribution as a capital gain. You should report it on line 2c, Part I of Schedule D, if it is a short-term gain or on line 9c, Part II of Schedule D, if it is a long-term gain.

Stock sold short. If you borrow stock to make a short sale, you may have to pay the lender the dividends distributed while you maintain your short position. Your treatment of the payment depends on the kind of distribution for which you are reimbursing the lender of the stock.

If your payment is made for a liquidating distribution or stock distribution, or if you buy more shares equal to a stock distribution issued on the borrowed stock during your short position, you have a capital expense. You must add the payment to the cost of the stock sold short. See Publication 550 for more information about the tax treatment of short sales.

Expenses related to dividend income. You may deduct expenses related to dividend income only if you itemize your deductions on Schedule A (Form 1040). See Chapter 30 for general information about deducting expenses of producing income. See Publication 550 for information about reporting investment expenses that are allocated to you by a regulated investment company or mutual fund.

The sample return in Chapter 37 has an example on reporting dividend income on Form 1040A. The sample return in Chapter 38 has an example on reporting dividend income on Form 1040.

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10. Rental Income and Expenses

This chapter discusses rental income and expenses, including depreciation. It also explains how to report rental income and expenses on your return.

If you sell or otherwise dispose of your rental property, see Publication 527, *Residential Rental Property.*

If you have a loss from damage to, or from theft of, rental property, see Publication 549, *Condemnations and Business Casualties and Thefts.*

If you rent out a condominium or a cooperative apartment, some special rules apply to you even though you receive the same tax treatment as other owners of rental property. See Publication 527 for more information.

Rental Income

Rental income is any payment you receive for the use or occupation of property.

You generally must include in your gross income all amounts you receive as rent.

In addition to amounts you receive as normal rent payments, there are other amounts that may be rental income.

Advance rent. You must include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use. You deduct rental expenses when you pay or incur them.

Example. You sign a 10-year lease to rent your property. In the first year, you receive $5,000 as rent for the first year and $5,000 in advance as rent for the last year of the lease. You must include $10,000 in your income in the first year.

Security deposits. Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. However, if during any year, you keep part or all of the security deposit because your tenant does not live up to the terms of the lease, you must include the amount you keep in your income for that year.

If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. You must include it in your income when you receive it.

Payment for cancelling a lease. If your tenant pays you to cancel a lease, the amount you receive is rent. You must include the payment in your income for the year you receive it whether you use the cash or accrual method of accounting.

Expenses paid by tenant. If your tenant pays any of your expenses, these payments are rental income. You must include them in your income. You may deduct the expenses that are otherwise deductible.

Property or services. If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.

If the services are provided at a stipulated price, that price will be the fair market value in the absence of evidence to the contrary.

Rental of a dwelling unit also used as a home. If you rent a dwelling unit that you also use as your home and you rent it for less than 15 days during the tax year, do not include the rent you receive in your gross income. You may not deduct expenses other than allowable interest, taxes, and casualty and theft losses. See *Vacation Homes and Other Dwelling Units,* later.

If you own a part interest in rental property, you must report your part of the rental income from the property.

Rental Expenses

This part discusses repairs and certain other expenses of renting property that you ordinarily may deduct from your gross rental income. It includes information on the expenses you may deduct if you rent part of your property, or if you change your property to rental use. Depreciation, which you also may deduct from your gross rental income, is discussed later.

If you own a part interest in rental property, you may deduct your part of the expenses that you paid.

When to deduct. You generally deduct your rental expenses in the year you pay or incur them.

Repairs and Improvements

You may deduct the cost of repairs that you make to your rental property. You may not deduct the cost of improvements. Improvements are capital expenditures. You recover the costs of improvements by taking depreciation (explained later).

Separate the costs of repairs and improvements and keep accurate records showing the cost of improvements. You will need to know these costs when you sell or depreciate your property.

A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If you make repairs as part of an extensive remodeling or restoration of your property, the whole job is an improvement.

An improvement adds to the value of your property, prolongs its useful life, or adapts it to new uses. Putting a recreation room in an unfinished basement, panelling a den, adding a bathroom or bedroom, putting decorative grillwork on a balcony, putting up a fence, putting in new plumbing or wiring, putting in new cabinets, putting on a new roof, and paving a driveway are examples of improvements.

If you make improvements to property before you begin renting it, add the cost of the improvement to the basis of the property.

Add to the basis of your property the amount the improvement actually cost you, including any amount you paid with borrowed funds, to make the improvement. This includes all direct costs, such as material and labor, but not your own labor. It also includes all expenses related to the improvement. For instance, if you had an architect draw up plans for remodeling your property, the architect's fee is a part of the cost of remodeling. Or, if you had your lot surveyed to put up a fence, the cost of the survey is a part of the cost of the fence.

Other Expenses

You may deduct from your gross rental income expenses for advertising, janitor and maid service, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses discussed below.

Salaries and wages. You may deduct reasonable salaries and wages you pay to your employees. You also may deduct bonuses you pay to your employees if, when added to their regular salaries or wages, the total is not more than reasonable pay.

You may deduct reasonable wages you pay to your dependent child if your child is your bona fide employee. However, you may not deduct the cost of meals and lodging for the child.

Rental payments for property. You may deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you may deduct an equal part of the cost each year over the term of the lease.

Rental of equipment. You may deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, contracts in the form of leases are purchase contracts. If so, the rent is part of the purchase price of a capital asset and you may not deduct it. However, you may be able to take a depreciation deduction on the asset. See *Depreciation,* later.

Insurance premiums. You may deduct insurance premiums you pay. If you pay the premiums for more than one year in advance, you may deduct a proportionate amount each year the insurance is in effect. You may not deduct the total premium in the year you pay it.

Local benefits. Generally, you may not deduct charges for local benefits that increase the value of your property, such as for putting in streets, sidewalks, or water and sewer systems. You must add them to the basis of your property. You may deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

Charges for services. You may deduct charges you pay for providing services for your rental property, such as water, sewer, and trash collection.

Renting Part of Your Property

If you rent part of your property, you must divide certain expenses between the part of the property used for rental purposes and the part of the property used for personal purposes as though you actually had two separate pieces of property.

You may deduct a part of some expenses, such as mortgage interest and property taxes, as a rental expense. You may deduct the other part, subject to certain limitations, only if you itemize your deductions. You also may deduct as a rental expense a part of other expenses that normally are nondeductible personal expenses, such as expenses for electricity or painting the outside of your house. You may deduct depreciation, discussed later, on the part of the property used for rental purposes as well as on the furniture and equipment you use for these purposes.

You do not have to divide the expenses that relate only to the rental part of your property. If you paint a room that you rent, or if you pay premiums for liability insurance in connection with renting a room in your home, your entire cost is a rental expense.

Dividing Expenses

If an expense is for both rental use and personal use, such as mortgage interest or heat for the entire house, you must divide the expense between the rental use and the personal use. You may use any reasonable method for dividing the expenses. The two most common methods are one based on the number of rooms in your home and one based on area.

The number of people involved may be the proper method to use to divide certain expenses. For example, if you provide board along with rooms you rent to tenants, the most accurate method of dividing food costs between rental and personal expenses may be one based on the total number of people eating the food. Or, if you rent an apartment and your tenants have unrestricted use of your telephone, the number of people using it may be the best method for dividing the monthly charge for the telephone.

Limits on Deductions for Rental Expenses

If you rent out part of your property and you also use that or another part of the same property for personal purposes during the year, your deductions for rental expenses for the property may be limited as discussed later, under *Vacation Homes and Other Dwelling Units.*

Business use of home. If you use part of your home for business (including work as an employee), your deductions for business use of your home are limited. See Publication 587, *Business Use of Your Home.*

Property Changed to Rental Use

If you change your home, apartment, or other property, or a part of it, to rental use at any time other than at the beginning of your tax year, you must divide yearly expenses such as depreciation, taxes, and insurance between rental use and personal use.

You may deduct as rental expenses only the part of the expense that is for the part of the year the property was used or held for rental purposes.

You may not deduct depreciation or insurance for any property or part of property held for personal use. However, you may deduct the allowable part of the interest and tax expenses for personal use as an itemized deduction on Schedule A (Form 1040).

If you change your property, or a part of it, to rental property, special rules apply for figuring your basis for depreciation. See *Property Changed to Business or Rental Use* in Chapter 15.

Example. You moved from your home in May 1987 and started renting it out on June 1, 1987. You may deduct as rental expenses seven-twelfths of your yearly expenses such as taxes and insurance.

You may deduct as rental expenses, starting with June, the amounts you pay for items generally billed monthly, such as utilities.

See *Personal home changed to rental use* later under *Modified Accelerated Cost Recovery System (MACRS)* for information about how to figure your deduction for depreciation.

Other limits. If you change property to rental use and later use part or all of it for personal purposes, there are other rules that apply to how much of your rental expenses you can deduct. These rules are explained next under *Vacation Homes and Other Dwelling Units.*

Vacation Homes and Other Dwelling Units

If you rent out part or all of a vacation home or other dwelling unit and you also use any part of the dwelling unit for personal purposes during the year, you must divide your expenses between the rental use and the personal use.

Depending on how your property was used, you may not be able to deduct any of your rental expenses, you may not be able to deduct all of your rental expenses in the year that you pay them, or you may not have to include any of the rent in your income.

Home and main home. The terms ***residence*** and ***principal residence,*** as used in prior editions of this publication, have been replaced with ***home*** and ***main home.*** If you have more than one home, your main home is the one you live in most of the time.

Dwelling Unit

For purposes of the rules that apply to vacation homes and other dwelling units, a dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property. It does not include property used exclusively as a hotel, motel, inn, or similar establishment.

Property is used exclusively as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Used as Home

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than 14 days and more than 10% of the number of days during the year that it is rented at a fair rental price. See *Personal Use* later for information on how to determine days of personal use.

To determine whether you use a dwelling unit as a home, do not count any day on which you use it for personal purposes as a day on which it is rented at a fair rental price.

Fair rental price. A fair rental price for your property generally is an amount that a person who is not related to you would be willing to pay. The rent you charge is ***not*** a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property.

Ask yourself the following questions when comparing another property with yours.

- Is it used for the same purpose?
- Is it approximately the same size?
- Is it in approximately the same condition?
- Does it have similar furnishings?
- Is it in a similar location?

If any of the answers are no, the properties probably are not similar.

Examples. The following examples show how to determine whether your rental property is a dwelling unit or a hotel, motel, inn, or similar property.

Example 1. You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rent the apartment to college students during the regular school year. You rent to them on a 9-month (273 days) lease.

During the summer, your nephews stay with you for a month (30 days) and live in the apartment. Your basement apartment is a dwelling unit (and not a hotel, motel, inn, or similar establishment) because you use it as a home (that is, for personal purposes for more than 14 days and more than 10% of the number of days for which it is rented).

Example 2. You rent out the guest bedroom in your home during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stays in the room, rent-free, for the last three weeks (21 days) in July.

The room itself is not a dwelling unit, but it is part of a dwelling unit. The room is not used exclusively as a hotel, motel, inn, or similar establishment because you use it as a home (that is, for personal purposes for more than 14 days and more than 10% of the number of days for which it is rented).

Example 3. You rent out a room in your home that is always available for occupancy by paying customers. You do not use the room yourself and you do not allow anyone other than paying customers to use the room. The room is used exclusively as a hotel, motel, inn, or similar establishment and is therefore not a dwelling unit.

Example 4. You own a cottage at the shore. You rent it out from June 1 through August 31, a total of 92 days. During 1988, the tenant who rented the cottage for the month of July was unable to use it from July 4 through July 8. The tenant allowed you to use the cottage for those 5 days. The tenant did not ask for a refund of or a reduction in the rent. Your family used the cottage for 3 of those days.

For purposes of determining whether you used the cottage as a home during 1988, you do not count those 3 days as days on which the cottage was rented at a fair rental price. The cottage was rented at a fair rental price for 89 days (92 − 3 = 89).

Personal Use

You use a dwelling unit for personal purposes on any day that it is:

1) Used by you or by any other person who has an interest in it, unless it is rented as a main home under a shared equity financing agreement (defined later),
2) Used by a member of your family or by a member of the family of any other person who has an interest in it, unless the family member uses the dwelling unit as their main home and pays a fair rental price (Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.)

and lineal descendants (children, grandchildren, etc.)),

3) Used by anyone under an arrangement that lets you use some other dwelling unit, or

4) Used by anyone at less than a fair rental price.

Rental to person with interest in unit. You use a dwelling unit for personal purposes if you rent it to someone who has an interest in it unless the rental is under a shared equity financing agreement.

Shared equity financing agreement. This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as their main home upon payment of rent to the other co-owner or owners.

Rental to family member. You do not use a dwelling unit for personal purposes if you rent it at a fair rental price to a member of your family who uses it as their main home (unless he or she has an interest in the unit).

Examples

The following examples show how to determine days of personal use.

Example 1. You and your neighbor are co-owners of a condominium at the beach. You rent the unit out to vacationers whenever possible. The unit is not used as a main home by anyone. Your neighbor uses the unit for two weeks every year.

Because your neighbor has an interest in the unit, both he and you are considered to have used the unit for personal purposes during those two weeks.

Example 2. You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.

Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

Example 3. You own a rental property that you rent to your son. Your son has no interest in this dwelling unit. He uses it as his main home. He pays you a fair rental price for the property.

Your son's use of the property is not personal use by you because your son is using it as his main home, he has no interest in the property, and he is paying you a fair rental price.

Example 4. You rent your beach house to Mary Smith. Mary rents her house in the mountains to you. You each pay a fair rental price.

You are using your house for personal purposes on the days that Mary uses it because your house is used by Mary under an arrangement that allows you to use her house.

Example 5. You rent an apartment to your mother at less than a fair rental price. You are using the apartment for personal purposes on the days that your mother rents it.

Days Not Counted as Personal Use

Some days you spend at the dwelling unit are not counted as days of personal use.

Repairs and maintenance. Any day that you spend repairing and maintaining your property on a full-time basis is not counted as a day of personal use. Do not count such a day as a day of personal use even if people related to you use the property for recreational purposes on the same day.

Use as home before or after renting. You do not have to count days on which you used the property as your main home as days of personal use if:

1) You used the property as your main home either before or after renting it or offering it for rent, ***and either***

2) You rented or tried to rent the property for 12 or more consecutive months, ***or***

3) You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

See Publication 527, *Residential Rental Property,* for more information about this situation.

Division of Expenses

If you use a dwelling unit for both rental and personal purposes, you must divide your expenses between the rental use and the personal use. For purposes of dividing your expenses:

- Any day that the unit is rented at a fair rental price is a day of rental use even if you have personally used the unit for that day, and
- A unit is ***not*** considered used for rental during the time that it is held out for rent but not actually rented.

Example. You offer your beach cottage for rent from June 1 through August 31 (92 days). Your family uses the cottage during the last 2 weeks in May (14 days). During 1988, you were unable to find a renter for the first week in August (7 days). The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. The cottage was not used at all before May 17 or after August 31.

The cottage was used for rental a total of 85 days (92 − 7 = 85). The days it was held out for rent but not rented (7 days) are not days of rental use. For purposes of dividing expenses, the July weekend on which you used it (2 days) is rental use because you received a fair rental price for the weekend.

You used the cottage for personal purposes for 14 days (the last 2 weeks in May).

Figuring Your Income and Deductions

How you figure your rental income and deductions depends on how much personal use you made of the property and how many days the property was rented.

General Rule

If you do not use a dwelling unit as a home, you divide your expenses between personal use and rental use based on the number of days it was used for each purpose.

Your deductible rental expenses can be more than your gross rental income. However, see *Passive Activity Limits,* later.

Where to report. Report the rental income and all of the rental expenses on Schedule E (Form 1040).

You can deduct allowable interest, taxes, and casualty losses for the personal use of the property on Schedule A (Form 1040) if you itemize deductions.

Property Used as a Home

If you use a dwelling unit as a home (that is, you use it for personal purposes more than 14 days and more than 10% of the number of days during the year that it is rented at a fair rental price), how you figure your rental income and deductions depends on how many days the unit was rented.

Rented less than 15 days. If you use a dwelling unit as a home and you rent it for less than 15 days during the year, you do not report any of the rental income. However, you may not deduct any expenses as rental expenses.

You can deduct your allowable interest, taxes, and casualty and theft losses on Schedule A (Form 1040) if you itemize deductions.

Rented 15 days or more. If you use a dwelling unit as a home and rent it for 15 days or more during the year, you report all your rental income. You must divide your expenses between the personal use and the rental use based on the number of days used for each purpose. If you had a net profit from the rental property for the year (that is, if your rental income is more than the total of your rental expenses, including depreciation), deduct all of your rental expenses. However, if you did not have a net profit from the rental property, you may not be able to deduct all of your rental expenses.

Note: If you had a ***casualty loss*** on the rental property during the year, see Publication 527 for information about how to figure your net rental loss.

If you cannot deduct all of your ***home mortgage interest*** because of the limit on the deduction of home mortgage interest, see Publication 527. The limit on the deduction of home mortgage interest is explained in Chapter 25.

Figuring your loss. If you:

- Did not have a net profit for the year from the rental property,
- Did not have a casualty loss on the rental property during the year, and
- Can deduct all of your mortgage interest paid during the year,

Deduct your rental expenses for the year in the following order:

1) Deduct the rental use portion of interest and taxes.

2) Deduct rental expenses that are not directly related to the dwelling unit itself. This includes expenses such as rental agent fees, office supplies, depreciation on office equipment used exclusively in the business of renting property, and advertising fees.

3) Deduct the rental use portion of any expenses not described in (1) or (2) (other than depreciation and other basis adjustments). This includes expenses such as repairs, insurance, and utilities. You may deduct these expenses only if your gross rental income is more than the total of the expenses described in (1) and (2). If these expenses are more than your gross rental income reduced by the expenses described in (1) and (2), deduct only the amount that is equal to your gross rental

income reduced by the expenses described in (1) and (2). See *Carryover of expenses,* later.

4) Deduct the rental use portion of depreciation and other basis adjustments to that rental property. You may deduct depreciation and other basis adjustments only if your gross rental income is more than the total of the deductions in (1), (2), and (3). If your depreciation and other basis adjustments are more than your gross rental income reduced by the total of the expenses in (1), (2), and (3), deduct only the amount that is equal to your gross rental income reduced by those expenses. See *Carryover of expenses,* later.

Where to report. Report your rental income and all your deductible expenses for the rental use on Schedule E (Form 1040). You deduct allowable interest and taxes for the personal use of the property on Schedule A (Form 1040) if you itemize deductions.

Carryover of expenses. If the total of your rental expenses is more than your gross rental income, the expenses that you are not allowed to deduct may be carried forward to the next year and treated as rental expenses for the same property. Any expenses carried forward to next year will be subject to any applicable limits next year.

Not Rented For Profit

If you do not expect to make a profit from the rental of a dwelling unit, you can deduct your rental expenses only up to the amount of your rental income. You must deduct your expenses using the rules explained in Publication 535, *Business Expenses.* You can ***not*** carry forward your rental expenses that are more than your rental income.

Where to report. You report your rental income on line 18, Form 1040. You claim your deductible rental expenses as a miscellaneous deduction on line 21, Schedule A (Form 1040) if you itemize deductions.

Most miscellaneous deductions, including these, are deductible only to the extent the total is more than 2% of your adjusted gross income. For more information about miscellaneous deductions, see Chapter 30.

Depreciation

Depreciation is the annual deduction you take to recover the cost of rental property that is used for more than one year.

If you have rental property with a life of more than one year, you claim depreciation deductions over the recovery period of the property.

Several factors determine how much depreciation you can deduct. The main factors are: (1) your basis in the property, and (2) the recovery period for the property.

You may deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange. Use Form 4562, *Depreciation and Amortization,* to report your depreciation.

You should claim the correct amount of depreciation each tax year. If you did not deduct depreciation in earlier years, you may not deduct the unclaimed depreciation in the current or any later tax year. However, you may be able to claim the depreciation on an amended return (Form 1040X) for the earlier year. See *Amended Returns* in Chapter 1 for more information.

The Tax Reform Act of 1986 generally changed the accelerated cost recovery system (ACRS) of depreciation for tangible property placed in service after 1986. The new system is referred to as the modified accelerated cost recovery system (MACRS) to distinguish it from ACRS.

There are now three systems involved in the computation of depreciation. The depreciation system that applies to a particular piece of property is determined by the type of property and when the property was placed in service. For tangible property, you use:

1) MACRS if placed in service after 1986,
2) ACRS if placed in service after 1980 but before 1987, or
3) Straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

This chapter discusses MACRS only. If you need information about any other method of depreciation, see Publication 534, *Depreciation.*

Cannot be more than basis. The total of all your yearly depreciation deductions cannot be more than your cost or other basis of the property. For this purpose, the total depreciation must include any depreciation that you were allowed to claim, even if you did not claim it.

Cooperative apartments. If you are a tenant-stockholder in a cooperative housing corporation and you rent your cooperative apartment to others, you may deduct your share of the corporation's depreciation. See Publication 527, *Residential Rental Property,* for information on how to figure your depreciation deduction.

Modified Accelerated Cost Recovery System (MACRS)

The modified accelerated cost recovery system (MACRS) applies to all tangible property placed in service after December 31, 1986 (after July 31, 1986, if elected).

If you placed your property in service before 1987, continue to use the same method of figuring depreciation that you used in the past.

Personal home changed to rental use. If you changed your home to rental use after 1986, the depreciation method you use depends on when you placed the property in service (explained later) as your home. If you used the property as your home before 1981, use the straight line or declining balance method. If you began using the property as your home after 1980, use MACRS. The straight line and declining balance methods are explained in Publication 534.

Caution: As this publication was being prepared for print, Congress was considering legislation that would provide that any real property acquired before 1987 and changed after 1986 from personal use to a business or income producing use is depreciated under MACRS. For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Property Classes Under MACRS

Each item of property that can be depreciated is assigned to a property class. The recovery period of a piece of property depends on the class the property is in. The property classes are:

3–year property,
5–year property,
7–year property,
10–year property,
15–year property,
20–year property,
Nonresidential real property, and
Residential rental property.

The class to which property is assigned is determined by its class life. Class life is discussed in Publication 534.

Optional tables. There are optional percentage tables in Publication 534 that you can use to figure your depreciation under MACRS.

Recovery Periods

Under MACRS, tangible property usually used in rental activities that you place in service after 1986, (after July 31, 1986, if elected) falls into one of the following classes. The other recovery classes are discussed in Publication 534.

1) ***5–year property.*** This class includes property with a class life of more than 4 years but less than 10 years, such as computers and peripheral equipment, office machinery (typewriters, calculators, copiers, etc.), automobiles, and trucks.

   Note. Depreciation on automobiles and computers is limited. See *Passenger Automobiles* and *Partial Business Use of Listed Property* in Publication 534.

2) ***7–year property.*** This class includes property with a class life of 10 years or more but less than 16 years, such as office furniture and fixtures (desks, files, etc.), and as designated, any single purpose agricultural or horticultural structure. This class also includes any property that does not have a class life and that has not been designated by law as being in any other class.

3) ***15–year property.*** This class includes property with a class life of 20 years or more but less than 25 years. It includes roads and shrubbery (if depreciable).

4) ***Nonresidential real property.*** This class includes
   - Any real property that is not residential rental property (defined later), and
   - Any real property that is section 1250 property (defined later) with a class life of 27.5 years or more.

Nonresidential real property is depreciated over 31.5 years.

5) ***Residential rental property.*** This class includes any real property that is a rental building or structure (including mobile homes) for which 80% or more of the gross rental income for the tax year is rental income from dwelling units. If you live in any part of the building or structure, the gross rental income includes the fair rental value of the part you live in. This property is depreciated over 27.5 years.

A dwelling unit is a house or an apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, inn, or other establishment where more than half of the units are used on a transient basis.

Placed in Service

Property is considered placed in service when it is in a condition or state of readiness and availability for use in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity.

Basis

To deduct the proper amount of depreciation each year, you must first determine your basis in the property you intend to depreciate. The basis used for figuring depreciation is your original basis in the property increased by any improvements made to the property. Your original basis is usually the purchase price. However, if you acquire the property in some other way, such as inheriting it, getting it as a gift, or building it yourself, you may have to figure your original basis in another way. Other adjustments could also affect your basis. See Chapter 15.

Depreciation Methods

For property in the 5– or 7–year classes, you use the double (200%) declining balance method over 5 or 7 years and a half-year convention (defined later) or mid-quarter convention (defined later), if applicable. For property in the 15–year class, you use the 150% declining balance method over 15 years and the applicable convention.

For these classes of property, change to the straight line method for the first tax year for which that method when applied to the adjusted basis at the beginning of the year will yield a larger deduction. You must use the straight line method and a mid-month convention (defined later) for nonresidential real property and residential rental property. See *Figuring MACRS Depreciation*, later.

Instead of using the declining balance method, you may elect to use the straight line method with a half-year or mid-quarter convention over the recovery period. The election to use the straight line method for a class of property applies to all property in that class that is placed in service during the tax year of the election.

The election is made by entering "SL" and "½", "1/12", or "¼" in Column (e) of Section B, Part 1 of Form 4562, *Depreciation and Amortization*. Once made, the election to use the straight line method over the recovery period may not be changed (see also *Alternate MACRS Method*, later).

Caution: As this publication was being prepared for print, Congress was considering legislation that would allow you to choose to use the 150% declining balance method over the class life or 12 years, if no class life, for property other than residential rental and nonresidential real property. For additional information on legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Declining balance method. To figure your MACRS deduction, first determine your declining balance rate of depreciation. This is determined by dividing the specified declining balance percentage (150% or 200%) by the recovery period. For example, for 5–year property, you divide 2.00 (200%) by 5 to get .4 (40%). For 15–year property, you divide 1.5 (150%) by 15 to get .1 (10%).

Multiply the adjusted basis of the property by the declining balance rate and apply the applicable convention to figure your depreciation for the first year. In later years,

1) Adjust your basis for the amount of depreciation allowable for the earlier years (that is, subtract that amount from your basis), then
2) Multiply your adjusted basis by the same rate used in the first year.

Follow steps (1) and (2) each year that you use the declining balance method.

Declining balance rates. The following table shows the applicable declining balance rate for each class of property and the first year for which the straight line method will give an equal or greater deduction.

Class	Declining Balance Rate	Year
5	40%	4th
7	28.57%	5th
15	10%	7th

Straight line method. To figure your MACRS deduction under the straight line method, you must figure a new depreciation rate for each tax year in the recovery period. For any tax year, figure the straight line rate by dividing the number 1 by the years remaining in the recovery period at the beginning of the tax year. Multiply the unrecovered basis of the property by the straight line rate. The depreciation is figured for the first year using the applicable convention (see *Conventions* later). If the remaining recovery period at the beginning of the tax year is less than 1 year, the straight line rate for that tax year is 100%.

Example. Using the straight line method for property with a 5–year recovery period results in a straight line rate of 20% (1 divided by 5) for the first tax year. After applying the half-year convention, the first year rate is 10% (20% divided by 2).

At the beginning of the second year, the remaining recovery period is 4 ½ years because of the half-year convention. The straight line rate for the second year is 22.2222% (1 divided by 4.5).

To figure your depreciation deduction for the second year:

1) Subtract the depreciation taken in the first year from the basis of the property, and
2) Multiply the remaining basis by the second year rate.

Residential rental and nonresidential real property. In the first year you claim depreciation for residential rental and nonresidential real property, you can only claim depreciation for the number of months the property is in use and you must use the mid-month convention (defined later). Also, for the first year of depreciation under the alternate MACRS method (described later), you must use the applicable convention to figure your depreciation deduction.

Conventions

In the year that you place property in service or in the year that you dispose of property, you are allowed depreciation for only a part of the year. The part of the year (or convention) depends on the class of the property.

A half-year convention is used to figure the deduction for property other than nonresidential real and residential rental property. Under a special rule, a mid-quarter convention may have to be used as discussed later. For nonresidential real and residential rental property, a mid-month convention applies in all situations.

Half-year convention. Under MACRS, the half-year convention treats all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, in the middle of that tax year.

A half year of depreciation is allowable for the first year property is placed in service, regardless of when the property is placed in service during the tax year. For each of the remaining years of the recovery period, you will take a full year of depreciation. If you hold the property for the entire recovery period, a half year of depreciation is allowable for the year following the end of the recovery period. If you dispose of the property before the end of the recovery period, a half year of depreciation is allowable for the year of disposition.

Mid-quarter convention. If during the last 3 months of a tax year,

1) You place in service depreciable property other than nonresidential real and residential rental property, and
2) The total bases of that property is more than 40% of the total bases of all such depreciable property you place in service during the year (whether or not all of the property is subject to MACRS),

you use a mid-quarter convention instead of a half-year convention.

Under a mid-quarter convention, all property placed in service, or disposed of, during any quarter of a tax year is treated as placed in service, or disposed of, at the middle of the quarter.

Example. During 1988, John Joyce purchases a dishwasher for $400, which he places in service in January; used furniture for $100, which he places in service in September; and a refrigerator for $500, which he places in service in October. John uses the calendar year as his tax year. The total bases of all property placed in service in 1988 is $1,000. Since the basis of the refrigerator ($500), which was placed in service during the last 3 months of his tax year, exceeds 40% of the total bases of all property ($1,000) placed in service during 1988, John must use the mid-quarter convention for all three items. The dishwasher, refrigerator, and used furniture are 7-year property under MACRS.

Caution: As this publication was being prepared for print, Congress was considering legislation that would add the following rules concerning the mid-quarter convention:

1) Only property depreciable under MACRS is to be taken into account in determining if the mid-quarter convention must be used, and
2) Property placed in service and disposed of in the same year is not taken into account in determining if the mid-quarter convention must be used.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Mid-month convention. Under a mid-month convention all property placed in service, or disposed of, during any month is treated as placed in service, or disposed of, in the middle of that month.

Additions or Improvements to Property

Figure the depreciation deduction for any additions to, or improvement of, any property as if the property had been placed in service at the same time as the addition or improvement.

The MACRS class for the addition or improvement is determined by the MACRS class of the property to which the addition or improvement is made. Figure depreciation beginning on the date the addition or improvement is placed in service, or, if later, the date the property to which the addition or improvement was made is placed in service.

Example. You own a residential rental house that you are depreciating under ACRS. If you put an addition onto the house, and you place the improvement in service after 1986, you use MACRS for the addition. Under MACRS the addition would be depreciated as residential rental property.

Figuring MACRS Depreciation

Optional depreciation tables, shown later, may be used in computing annual depreciation under MACRS. The percentages in Tables A, B, and C make the change from declining balance to straight line in the year that straight line will yield a larger deduction. See *Depreciation methods* earlier. If you do not choose to use the optional tables, see Publication 534, *Depreciation,* for information on how to figure depreciation.

Personal property. The depreciation deduction is figured by multiplying your basis (explained earlier), unreduced by any depreciation allowed or allowable, in the property by a certain percentage. The percentages for the first 4 years are shown in the following tables for 5–, 7–, and 15–year property. The tables take the half-year and mid-quarter conventions into consideration in figuring percentages.

Use Table A for 5–year property, Table B for 7–year property, and Table C for 15–year property. Use the percentage in the first column (half-year convention) unless you must use the mid-quarter convention (explained earlier). If you are required to use the mid-quarter convention, use the first, second, third or fourth quarter columns depending on which quarter of the calendar year you place the property in service.

If you choose the straight line depreciation method, see Publication 534 for information on how to figure the depreciation.

Example 1. You purchased a stove and refrigerator and placed them in service on February 1, 1988. Your basis in the stove is $300 and your basis in the refrigerator is $500. You use the year 1 line of Table B, in the Half-year convention column to compute the depreciation on the stove and refrigerator. Your 1988 depreciation deduction on the stove is $43 ($300 × .1429). Your 1988 depreciation deduction on the refrigerator is $71 ($500 × .1429).

Example 2. Assume the same facts in Example 1, except you buy the refrigerator in October 1988 instead of February. You cannot use the Half-year convention column to figure depreciation on the stove and refrigerator. Your basis of the refrigerator ($500) placed in service in the last 3 months of the tax year is more than 40% of the total bases of all property ($800) placed in service during 1988. You must use the mid-quarter convention columns to figure your depreciation. Because the stove was placed in service in the first quarter of the year, you find the depreciation percentage on the year 1 line of Table B under the first quarter column to figure the depreciation deduction. Your 1988 depreciation deduction on the stove is $75 ($300 × .25). You use the fourth quarter column of Table B to find the depreciation percentage on the refrigerator since you placed it in service in the fourth quarter of 1988. Your depreciation deduction on the refrigerator is $18 ($500 × .0357).

Real property. Tables I and II, illustrated later, give the percentages for the first 4 years for real property placed in service after 1986. Find the table for the class of property, residential rental or nonresidential real property. Then find the column for the month that you placed the property in service. Use the percentages listed for that month for your depreciation deduction. The mid-month convention is considered in the percentages used in the tables.

Example. You purchased a single family rental house and placed it in service on February 1, 1988. Your basis in the house is $80,000. You use the percentage from the first line (year 1) of Table I, residential rental property, Column 2 (February), to compute your depreciation. Your 1988 depreciation deduction is $2,546 ($80,000 × .03182).

Alternate MACRS Method

If you choose, you may use an alternate MACRS method for most property. Under this method depreciation is figured using the straight line method of depreciation.

Table A **MACRS 5-Year Property**

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68

Table B **MACRS 7-Year Property**

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06

Table C **MACRS 15-Year Property**

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00

Table I

Residential Rental Property (27.5-year)

Year	Use the column for the month of taxable year placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	3.485%	3.182%	2.879%	2.576%	2.273%	1.970%	1.667%	1.364%	1.061%	0.758%	0.455%	0.152%
2	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%
3	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%
4	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%

Table II

Nonresidential Real Property (31.5-year)

Year	Use the column for the month of taxable year placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	3.042%	2.778%	2.513%	2.249%	1.984%	1.720%	1.455%	1.190%	0.926%	0.661%	0.397%	0.132%
2	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%
3	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%
4	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%

The recovery periods for property under the alternate MACRS method are as follows:

Property	Recovery Period
Personal property with no class life	12 years
Nonresidential real and residential rental property	40 years
Section 1245 property that is real property with no class life	40 years
Automobiles and light duty trucks	5 years
Computers and peripheral equipment	5 years
Most other property	Class life

The class life assigned to many properties can be found in the *Table of Class Lives and Recovery Periods*, at the back of Publication 534. If your property is not listed in the table, it is considered to have no class life.

The convention for nonresidential real and residential rental property is the mid-month convention. For all other property, use the half-year or mid-quarter convention.

Election. You make the election to use the alternate MACRS method by entering the depreciation on line 7 of Section B, Part 1 of Form 4562, *Depreciation and Amortization*.

The election of the alternate MACRS method for a class of property applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for nonresidential real and residential rental property.

The election to use the alternate MACRS method once made cannot be changed.

Excluded Property

You cannot use MACRS for certain personal property placed in service before 1987 (before August 1, 1986, if election made) that is transferred after 1986 (after July 31, 1986, if election made). Generally, if you acquired the property from a related party, or if you or a related party used the property before 1987, you may not use MACRS. Property that does not come under MACRS must be depreciated under ACRS or one of the other methods of depreciation, such as straight line or declining balance. In addition, you may elect to exclude certain property from the application of MACRS. See Publication 534 for more information.

If you placed property in service after 1980 and before 1987 (before August 1, 1986, if elected), continue to depreciate it under the accelerated cost recovery system (ACRS). If you placed property in service, or converted a personal residence to rental property after 1986 (after July 31, 1986, if elected), use MACRS to figure your depreciation. See *Modified Accelerated Cost Recovery System (MACRS)*, discussed earlier. If you began renting the property before 1981, continue using the same method of depreciation that you used in the past.

Other Rules About Depreciable Property

In addition to the rules about what methods you can use, there are other rules you should be aware of if you use depreciable property.

If you dispose of depreciable property at a profit, you may have to report, as ordinary income, all or part of the profit. See Publication 544, *Sales and Other Dispositions of Assets*.

Additional tax on preference items. If you use accelerated depreciation, you may have to file Form 6251, *Alternative Minimum Tax—Individuals*. Accelerated depreciation includes MACRS and ACRS and any other method that allows you to deduct more depreciation than you could deduct using a straight line method. For more information, see Publication 909, *Alternative Minimum Tax for Individuals*.

Limits on Rental Losses

Generally, you cannot deduct losses from rental real estate activities unless you have income from passive activities. See *Passive Activity Limits*, discussed later.

At-risk rules limit the amount of deductible losses from holding most real property placed in service after 1986.

Losses from passive activities are first subject to the at-risk rules.

Exception. If your rental losses are less than $25,000 ($12,500 if married filing separately), the passive activity limits probably do not apply to you. See *Losses From Rental Real Estate Activities*, later.

At-Risk Rules

The at-risk rules place a limit on the amount of deductible losses from activities often described as tax shelters. Holding real property (other than mineral property) was not subject to the at-risk rules before 1987.

Generally, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount a taxpayer has at risk in the activity at the end of the tax year. A taxpayer is considered at risk in an activity to the extent of cash and the adjusted basis of other property the taxpayer contributed to the activity and certain amounts borrowed for use in the activity. See Publication 925, *Passive Activity and At-Risk Rules*, for more information.

Passive Activity Limits

You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities.

Any rental activity is a passive activity. For this purpose, a rental activity generally is an activity the income from which consists of payments principally for the use of tangible property, rather than for the performance of substantial services.

Form 8582, *Passive Activity Loss Limitations*, is used to figure the amount of any passive activity loss for the current tax year for all activities and the amount of the passive activity loss allowed on your tax return.

Losses From Rental Real Estate Activities

You are allowed to deduct up to $25,000 ($12,500 if married filing separately and living apart from your spouse the entire year) of losses from rental real estate activities in which you ***actively participated*** during the tax year. The offset allows you to deduct up to $25,000 of otherwise unallowable losses from rental real estate activities from other income (nonpassive income). The $25,000 ($12,500) figure is reduced if your adjusted gross income is more than $100,000.

Active participation. You actively participate in a rental real estate activity if you own at least 10% of the rental property. For these purposes, you are considered to own any portion of the property owned by your husband or wife.

Additional information on the passive loss limits, including information on the treatment of unused disallowed passive losses and credits and the treatment of gains and losses realized on the disposition of a passive activity, is provided in Publication 925.

Caution: As this publication was being prepared for print, Congress was considering legislation that would allow you, when figuring your passive activity losses, to treat any income, deductions, gain, or loss related to the rental of property as items not related to a passive activity if you used the property as your home (that is, you used it for personal purposes for more than 14 days and more than 10% of the number of days for which it was rented at a fair rental price). For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

How To Report Your Rental Income and Expenses

Report rental income on your return for the year you actually or constructively receive it. You are considered to constructively receive income when it is made available to you, for example, by being credited to your bank account.

For more information about when you constructively receive income, see *Accounting Methods* in Chapter 1.

Expenses carried over. If you could not deduct all of your 1987 rental expenses because you used your property as a home, treat the part you could not deduct in 1987 as a 1988 rental expense.

Caution: As this publication was being prepared for print, Congress was considering legislation that would allow you to deduct the expenses carried over to a year only up to the amount of your gross rental income for the year, even if you did not use the property as your home for the next year. For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Where to report. Where you report rental income and expenses, including depreciation, depends on whether you provide certain services to your tenant.

If you rent out buildings, rooms, or apartments, and provide only heat and light, trash collection, etc., you normally report your rental income and expenses in Part I of Schedule E (Form 1040), *Supplemental Income Schedule*.

If you provide additional services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C (Form 1040), *Profit or Loss from Business*. For information on Schedule C, see Publication 334, *Tax Guide for Small Business*. You also may have to pay self-employment tax on your rental income. See Publication 533, *Self-Employment Tax*.

Schedule E

Use Part I of Schedule E (Form 1040) to report your rental income and expenses. List your total income, expenses, and depreciation for each rental property. Be sure to answer the questions on lines 2 and 3. On line 21 of Schedule E (Form 1040), show the depreciation you are claiming. To report your depreciation deduction, use Form 4562, *Depreciation and Amortization.*

If you have more than three rental properties, use as many Schedules E as are needed to list the properties. Complete lines 1, 2, and 3 for each property. However, fill in the "Totals" column for lines 4, 5, 12, 20, 21, and 25 through 29 on only one Schedule E. The figures in the total column on that Schedule E should be the combined totals of all the schedules. If you need to use page 2 of Schedule E, use page 2 of the Schedule E on which you entered the combined totals.

Example. Eileen Green owns a townhouse that she rents out. She receives $1,100 a month rental income. Her expenses for the year are as follows:

Fire insurance (1–year policy)	$ 200
Mortgage interest	5,000
Fee paid to real estate company for collecting monthly rent	572
General repairs	175
Real estate taxes imposed and paid in 1988	800

Eileen bought the property and placed it in service on February 1, 1988. Her basis for depreciation of the townhouse is $65,000. She is using MACRS with a 27.5–year recovery period. On April 1, 1988, Eileen bought a new dishwasher for the rental property at a cost of $425. She uses MACRS with a 7-year recovery period. She uses Form 4562 to figure and report her MACRS deduction.

Eileen figures her net rental income or loss for the townhouse as follows:

Total rental income received ($1,100 × 11)		$12,100
Minus Expenses:		
Fire insurance	$ 200	
Mortgage interest	5,000	
Real estate fee	572	
General repairs	175	
Real estate taxes	800	
Total expenses		6,747
Balance		$ 5,353
Minus Depreciation:		
On townhouse ($65,000 × 3.182%)	$2,068	
On dishwasher ($425 × 14.29%)	61	
Total depreciation		2,129
Net rental income for townhouse		$ 3,224

Form 1098. If you paid $600 or more of mortgage interest on your rental property, you should receive a Form 1098, *Mortgage Interest Statement,* or a similar statement showing the interest you paid for the year. If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid interest on, the mortgage, and the other person received the Form 1098, attach a statement to your return showing the name and address of the other person. In the left margin of Schedule E, next to line 12, write "see attached."

11. Retirement Plans, Pensions, and Annuities

Important Changes for 1988

Simplified General Rule for figuring pension taxability. If your annuity starting date is after July 1, 1986, beginning in 1988 you may be able to use a Simplified General Rule for figuring the tax-free amount of your pension.

Capital gain treatment of lump-sum distributions. In 1988, the capital gain treatment of lump-sum distributions from pension plans will begin to be phased out, unless you were born on or before January 1, 1936.

Tax on excess distributions. The amount of retirement distributions that may be made to you during the year without incurring the tax on excess distributions has been increased to $117,529 for 1988 (from $112,500 that applied for 1987).

Tax on excess accumulations (failure to make minimum distributions). For tax years beginning ***after*** 1988, a 50% excise tax will apply to required minimum distributions that are not made during the year. Generally, you must begin receiving distributions from your pension plan by April 1 of the year following the calendar year in which you reach age 70½.

This chapter explains how to report amounts received from employee pensions or annuities and disability pensions or annuities.

Information on amounts received from an individual retirement arrangement (IRA), as well as general information on IRAs, can be found in Chapter 20.

Employee Pensions or Annuities

Generally, if you did not pay any part of the cost of your employee pension or annuity, and your employer did not withhold part of the cost of the contract from your pay while you worked, the amounts you receive each year are fully taxable. You must report them on your income tax return.

If you pay part of the cost of your annuity, you will not be taxed on the part of the annuity you receive that represents a return of your cost. Any additional amount you receive will be taxable. You use either the ***General Rule,*** the ***Simplified General Rule,*** or the ***Three-Year Rule*** to determine the taxable and nontaxable parts of your pension or annuity.

Railroad retirement benefits. Part of the railroad retirement benefits you receive are treated like social security benefits, and part are treated like an employee pension. For information about railroad retirement benefits treated as an employee pension, see Publication 575, *Pension and Annuity Income.*

Credit for the elderly or the disabled. If you receive a pension or annuity, you may be able to take this credit. See Chapter 34 for more information about this credit.

Estimated tax. If you receive a pension or annuity, you may have to pay estimated tax. See *Estimated Tax* in Chapter 5 and *Withholding of Tax,* later.

Loans. If you borrow money from an employer's qualified pension or annuity plan, a tax-sheltered annuity program, a government plan, or from a contract purchased under any of these plans, you may have to treat the loan as a distribution. This means that you may have to include all or part of the amount borrowed in income. Even if you do not have to treat the loan as a distribution, you might not be able to deduct the interest on the loan in some situations. For more information, see Publication 575.

Cost

Before you can determine what part, if any, of your pension or annuity benefits is taxable, you must first determine your investment in the contract (your cost). Your total cost in the plan includes everything that you paid. This also includes amounts your employer paid that you were required to include in your income at the time paid. From this total cost paid or considered paid by you, subtract any refunds of premiums, rebates, dividends, unrepaid loans, or other tax-free amounts you received before the later of the annuity starting date or the date on which you received your first payment. Under the General Rule, subtract any amount allocable to a refund feature in your contract.

The ***annuity starting date*** is the later of the first day of the first period that you receive a payment from the plan or the date on which the plan's obligation became fixed.

Your employer or the organization that pays you the benefits (plan administrator) should be able to tell you exactly how much your total investment in the contract (your cost) is. But, when using the General Rule, you will probably need to know both your investment in the contract before July 1986, and your investment after June 1986. Since your employer or plan administrator may not be able to make this breakdown, you should keep records that will show this information.

Foreign employment. If you worked before 1963 in a foreign country and your employer paid into your retirement plan, a part of those payments may be considered part of your cost. For more information, see *Foreign employment* in Publication 575.

General Rule

If your annuity starting date is after July 1, 1986, you must use either the General Rule or, if you qualify, the Simplified General Rule. Also, if your annuity starting date was before July 2, 1986, and you are not recovering your cost using the Three-Year Rule, you must use the General Rule. Under this rule, you divide your cost by the amount you expect to receive (your expected return). The result of this division is the exclusion percentage.

You then multiply the first regular periodic payment you receive by the exclusion percentage to figure the dollar amount of each pension or annuity payment that is not taxed.

The tax-free amount remains the same even if the total payment increases. If your annuity starting date was before 1987, you continue to exclude the same amount from each annuity payment even if you outlive the life expectancy factor used to figure your expected return. The rest of each payment is fully taxable. If your annuity starting date is after [illegible] your total exclusion over the years may not exceed your total cost reduced by the value of any refund feature.

If you, or a survivor annuitant, dies before the cost is recovered, an itemized deduction (not subject to the 2% floor on certain miscellaneous itemized deductions) is allowed for the unrecovered cost on your, or your survivor's, final income tax return.

For more information on the General Rule, see Publication 575. That publication tells you how to figure your expected return and exclusion percentage, and contains certain actuarial tables you will need.

Simplified General Rule

If you retired and your annuity starting date is after July 1, 1986, you may be able to use a computation simpler than the General Rule explained earlier to figure the taxable and nontaxable parts of your annuity. You can use this simpler method only if:

- The annuity payments are for either (a) your life, or (b) your life and that of your beneficiary, and
- The annuity payments are from a qualified employee plan, an employee annuity, or a tax-sheltered annuity, and
- As of the annuity starting date, either you were under age 75 or, if you were 75 or older, the number of years of guaranteed payments was fewer than 5.

If you meet these conditions and you choose the Simplified General Rule, use the following worksheet to figure your taxable pension for 1988. In completing this worksheet, use your age at the birthday preceding your annuity starting date. Be sure to keep the worksheet; it will help you figure your 1989 taxable pension.

Worksheet for Simplified General Rule

1. Total pension received this year. Also enter this amount on Form 1040, line 17a		
2. Total cost of the contract, including any death benefit exclusion		
3. If you are:	Enter:	
55 and under	300	
56 – 60	260	
61 – 65	240	
66 – 70	170	
71 and over	120	
4. Divide amount on line 2 by the number on line 3, and round to two decimal places		
5. Multiply line 4 by the number of months for which this year's payments were made		
6. Taxable pension for year. Subtract line 5 from line 1 (do not enter less than zero). Also, enter this amount on Form 1040, line 17b. If your Form W–2P shows a larger taxable amount, use the amount on line 6 instead of the amount from the Form W–2P		
Amount of cost to be recovered in tax years after 1988. (Fill out only if your annuity starting date was after December 31, 1986.)		
7. Enter amount from line 2		
8. Enter amount from line 5 plus any amount recovered tax-free in 1987		
9. Subtract line 8 from line 7. This is your remaining cost		

The following example illustrates the simplified method:

Example. Bill Kirkland, age 65, began receiving retirement benefits under a joint and survivor annuity to be paid for the joint lives of Bill and his wife, Kathy. His annuity starting date was January 1, 1988. He had contributed $24,000 to the plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of $1,000 a month, and Kathy is to receive a monthly survivor benefit of $500 upon Bill's death.

Bill chooses to use the Simplified General Rule computation. He fills in the worksheet as follows:

Worksheet for Simplified General Rule

1. Total pension received this year. Also enter this amount on Form 1040, line 17a		$12,000
2. Total cost of the contract, including any death benefit exclusion		$24,000
3. If you are:	Enter:	
55 and under	300	
56 – 60	260	
61 – 65	240	
66 – 70	170	
71 and over	120	240
4. Divide amount on line 2 by the number on line 3, and round to two decimal places		$100.00
5. Multiply line 4 by the number of months for which this year's payments were made		$1,200
6. Taxable pension for year. Subtract line 5 from line 1 (do not enter less than zero). Also, enter this amount on Form 1040, line 17b. If your Form W–2P shows a larger taxable amount, use the amount on line 6 instead of the amount from the Form W–2P		$10,800
Amount of cost to be recovered in tax years after 1988. (Fill out only if your annuity starting date was after December 31, 1986.)		
7. Enter amount from line 2		$24,000
8. Enter amount from line 5 plus any amount recovered tax-free in 1987		$1,200
9. Subtract line 8 from line 7. This is your remaining cost		$22,800

Bill's tax-free monthly amount is $100 (see line 4 of the worksheet). If Bill lives to collect more than 240 monthly payments, Bill will have to include in his gross income the full amount of any annuity payments received after 240 payments have been made.

If Bill does not live to collect 240 monthly payments and Bill's wife, Kathy, begins to receive monthly payments, she will also exclude $100 from each monthly payment until 240 payments (Bill's and hers) have been collected. If she dies before 240 payments have been made, a miscellaneous itemized deduction (not subject to the 2% floor on miscellaneous deductions) will be allowed for the unrecovered cost on Kathy's final income tax return.

Death benefit exclusion. If you are a beneficiary of a deceased employee or former employee, you may qualify for a death benefit exclusion of up to $5,000, discussed later in this chapter. If you choose the Simplified General Rule and you qualify for the death benefit exclusion, you may increase the total investment in the pension or annuity contract (on line 2 of the worksheet) by the amount of the allowable death benefit exclusion.

However, the payer of the annuity cannot add the death benefit exclusion to the cost for reporting the tax-free and taxable parts of a payment on Form W–2P. Thus, there will be a difference in the amounts you will figure for yourself and the amounts the payer will figure. You must attach a signed statement to your income tax return stating that you are entitled to the death benefit exclusion in making the Simplified General Rule computation.

Example. Diane Greene, age 48, began receiving a $1,500 monthly annuity in 1988 upon the death of her husband. She received 10 payments in 1988. Her husband had contributed $25,000 to his qualified employee plan. In addition, Diane finds that she is entitled to a $5,000 death benefit exclusion for the annuity payments. She adds that amount to her husband's contributions to the plan, making a total investment in the contract of $30,000.

Diane chooses to use the Simplified General Rule. She fills out the worksheet as follows:

Worksheet for Simplified General Rule

1. Total pension received this year. Also enter this amount on Form 1040, line 17a		$15,000
2. Total cost of the contract, including any death benefit exclusion		$30,000
3. If you are:	Enter:	
55 and under	300	
56 – 60	260	
61 – 65	240	
66 – 70	170	
71 and over	120	300
4. Divide amount on line 2 by the number on line 3, and round to two decimal places		$100.00
5. Multiply line 4 by the number of months for which this year's payments were made		$1,000
6. Taxable pension for year. Subtract line 5 from line 1 (do not enter less than zero). Also, enter this amount on Form 1040, line 17b. If your Form W–2P shows a larger taxable amount, use the amount on line 6 instead of the amount from the Form W–2P		$14,000
Amount of cost to be recovered in tax years after 1988. (Fill out only if your annuity starting date was after December 31, 1986.)		
7. Enter amount from line 2		$30,000
8. Enter amount from line 5 plus any amount recovered tax-free in 1987		$1,000
9. Subtract line 8 from line 7. This is your remaining cost		$29,000

In completing Form W–2P, the payer of the annuity (Diane's husband's employer) chooses to report the taxable part of the annuity payments using the Simplified General Rule. However, since the payer does not adjust the investment in the contract by the death benefit exclusion, the payer figures the tax-free part of each monthly payment to be $83.33, as follows:

$$\frac{\text{Total investment: \$25,000}}{\text{Expected payments: 300}} = \$83.33 \quad \text{(Monthly return of investment)}$$

However, Diane had figured a $100 monthly tax-free amount (see line 4 of the worksheet). Because of this difference in the computations, the Form W–2P given by the payer to Diane will show a greater taxable amount than what she figured for herself. She should report on line 17b of Form 1040 only the smaller taxable amount based on her own computation. She must attach a signed statement to her income tax return stating that she is entitled to the death benefit exclusion in making the Simplified General Rule computation.

Changing the method. You may change the way you figure your pension cost recovery exclusion (from the General Rule to the Simplified General Rule, or the other way around) by filing amended returns for all your tax years beginning with the year in which you received your first annuity payment. You must use the same method for all years, unless you choose the Simplified General Rule for 1988 and later years but not for 1986 or 1987 (see the following discussion). Generally, you may make the change only within 3 years from the due date of your return for the year in which you received your first annuity payment (or, if later, within 2 years from the date the tax for that year was paid).

Annuity starting date before 1988. If your annuity starting date was before July 2, 1986, you cannot choose the Simplified General Rule at any time. If your annuity starting date is after July 1, 1986, and before January 1, 1988, you may:

1) Start to use the Simplified General Rule in 1988 without amending your 1986 or 1987 returns, or
2) Amend your 1987 (and, if applicable, your 1986) return to apply the Simplified General Rule to the annuity distributions for that year (or years).

If you choose to use the Simplified General Rule for 1988 without amending your prior returns, figure your taxable and nontaxable annuity amounts as of the actual annuity starting date in 1986 or 1987.

If you received your first annuity payment in 1987, and you choose to apply the Simplified General Rule to your 1987 distributions, file an amended return for 1987. If you received your first annuity payment in 1986, and you choose to apply the Simplified General Rule to your 1986 and 1987 distributions, file amended returns for both 1986 and 1987. You cannot choose the Simplified General Rule for 1987 only, while applying the General Rule to 1986; you must apply the Simplified General Rule to all years beginning with the year in which you received your first annuity payment if you choose to apply it to any of those years. See *Changing the method,* above.

Example. Jenny Rogers, age 67, retired in 1987 and began receiving a $500 monthly annuity payment in March of that year. She had contributed $12,750 to her retirement plan as of the annuity starting date. Using the General Rule, she recovered $700 tax-free in 1987.

For 1988, Jenny chooses to use the Simplified General Rule. She decides not to file an amended return for 1987. She fills out the worksheet for 1988 as follows:

Worksheet for Simplified General Rule

1.	Total pension received this year. Also enter this amount on Form 1040, line 17a		$6,000
2.	Total cost of the contract, including any death benefit exclusion		$12,750
3.	If you are:	Enter:	
	55 and under	300	
	56 – 60	260	
	61 – 65	240	
	66 – 70	170	
	71 and over	120 ...	170
4.	Divide amount on line 2 by the number on line 3, and round to two decimal places		$75.00
5.	Multiply line 4 by the number of months for which this year's payments were made		$900
6.	Taxable pension for year. Subtract line 5 from line 1 (do not enter less than zero). Also, enter this amount on Form 1040, line 17b. If your Form W–2P shows a larger taxable amount, use the amount on line 6 instead of the amount from the Form W–2P		$5,100

Amount of cost to be recovered in tax years after 1988. (Fill out only if your annuity starting date was after December 31, 1986.)

7.	Enter amount from line 2	$12,750
8.	Enter amount from line 5 plus any amount recovered tax-free in 1987	$1,600
9.	Subtract line 8 from line 7. This is your remaining cost	$11,150

Beginning in 1988, Jenny will exclude $75 from each monthly payment, until she has recovered her entire cost of $12,750. (For the payment in which her remaining cost is less than $75, she may only exclude the remaining cost.) The full amount of each subsequent payment will be taxable.

Three-Year Rule

If your annuity starting date was before July 2, 1986, and you will recover your cost within the first 3 years after the date you first received an amount as an annuity, you should be reporting your payments under the Three-Year Rule.

Under this rule, you exclude all the annuity payments from income until you fully recover your cost. Thereafter, all payments are fully taxable.

Example. Jean Smith retired on January 31, 1986, with a monthly annuity of $400. Her annuity cost was $9,950. During the first 3 years she will receive $14,400 (36 months × $400), which is more than her total cost. In 1986 she received $4,000 ($400 × 10) that was tax free. In 1987 she received $4,800 that also was tax free. However, in 1988 she must report $3,650 as income. This is figured as follows:

Worksheet from 1988 Form 1040 Instructions

1.	a.	Enter your cost	$9,950
	b.	Cost recovered in prior years	8,800
	c.	Subtract line 1b from line 1a	$1,150
2.		Amount received this year. Also enter this amount on Form 1040, line 17a	$4,800
3.		Enter amount from line 1c above	1,150
4.		Taxable amount. Subtract line 3 from line 2. Enter the result (but not less than zero). Also enter this amount on Form 1040, line 17b	$3,650

In 1989 and later years, the entire amount she receives will be taxable.

How to Report

Report your total annuity on line 17a, Form 1040, and the taxable part on line 17b. If your pension or annuity is fully taxable, enter it on line 17b; no entry is needed on line 17a.

If you receive more than one annuity that is not fully taxable, enter the total amount received from ***all*** partially taxable annuities on line 17a, Form 1040, and the taxable part on line 17b.

If you receive benefits from more than one program, such as a pension plan and a profit-sharing plan, you must account for each separately even though the benefits from both may be included in the same check. For example, benefits from one of your programs could be fully taxable, while the benefits from your other program could be taxable under the General Rule. Your former employer or the plan administrator should be able to tell you if you have more than one program.

If you file a joint return and you and your spouse each receive one or more pensions or annuities, report the total of the pensions and annuities on line 17a, Form 1040, and the taxable part on line 17b.

Survivors. If you, as the survivor of a retiree who had reported an annuity under the Three-Year Rule, receive a survivor annuity, you do not include your annuity payments in income until the cost has been recovered. Thereafter, you must include all your payments in income.

If the retiree had recovered all employee contributions before death, your survivor payments are fully taxable.

If the retiree was reporting the annuity payments under the General Rule, you should apply to your initial payment called for in the contract the same exclusion percentage as the retiree used. The resulting dollar exclusion will then remain fixed for as long as you receive your survivor annuity. Increases in the survivor annuity made after the original retiree's annuity starting date are fully taxable. If the annuity starting date is after 1986, the total exclusion over the years cannot exceed the cost minus the value of any refund feature.

If you are a survivor of an individual who died while still employed, you can, under some circumstances, add up to $5,000 to the decedent's cost to be recovered tax free. This ***death benefit exclusion,*** which is discussed later, is treated as an addition to the cost of the annuity. Publication 575 explains the taxation of the annuity under the General Rule.

Estate tax. If the annuity was a joint and survivor annuity and was included in the decedent's estate, an estate tax may have been paid on it. As the surviving annuitant, you may deduct, as an itemized deduction (not subject to the 2% floor on certain miscellaneous itemized deductions), the part of the total estate tax that was paid because of the annuity, provided that the deceased's annuity starting date occurred before his or her death. This amount cannot be deducted in one year. It must be deducted equally over your remaining life expectancy. See Publication 559, *Tax Information for Survivors, Executors, and Administrators,* for information on how to figure the deduction.

Death Benefit Exclusion

If you are the beneficiary of a deceased employee or former employee, the pension or annuity you get because of that person's death may qualify for a death benefit exclusion.

This exclusion is limited to $5,000. It generally applies to the amount by which the present value of the survivor annuity, figured as of the date of the employee's death, exceeds the larger of: (1) the employee's total regular contributions to the plan; or (2) the amount the employee had a nonforfeitable right (a right that cannot be taken away) to receive just before death.

If you are eligible for the exclusion, add it to the cost or unrecovered cost of the annuity when you figure your cost at the annuity starting date.

If you are the survivor under a joint and survivor annuity, the exclusion applies only if either:

1) The decedent died before receiving, or becoming entitled to receive, retirement pension or annuity payments, or
2) The decedent received disability income payments that were not treated as pension or annuity income.

For more information on the death benefit exclusion, see *Payments to beneficiaries of deceased employees* under *Life Insurance Proceeds* in Chapter 13, and *Death benefit exclusion* under *Investment in the Contract (Cost)* in Publication 575.

Lump-Sum Distributions

Lump-sum distributions you receive from a qualified retirement plan (an employer's pension, stock bonus, or profit-sharing plan that has received IRS approval) may be given special tax treatment. For information on a distribution you receive that includes employer securities, see Publication 575.

A lump-sum distribution is the distribution within a single tax year of an employee's entire balance, excluding certain amounts forfeited or subject to forfeiture, from all of the employer's qualified pension plans, all of the employer's qualified stock bonus plans, or all of the employer's qualified profit-sharing plans. The distribution must have been made:

1) Because of the employee's death,
2) After the employee reaches age 59½,
3) Because of the employee's (not including a self-employed individual) separation from service, or
4) After a self-employed individual becomes totally and permanently disabled.

A distribution you receive based on your ***voluntary deductible employee contributions (DECs)*** does not qualify as a lump-sum distribution.

Tax treatment. You may recover your ***cost basis*** in the lump sum tax-free. Also, you may be entitled to special tax treatment for the remaining part of the distribution.

In general, your ***cost basis*** consists of:

1) Your total nondeductible contributions to the plan;
2) The total of your taxable one-year term costs of life insurance;
3) Any employer contributions that were taxable to you; and
4) Repayments of loans that were taxable to you.

You must reduce this basis by amounts previously distributed to you tax-free.

Long-term capital gain treatment. If you were at least age 50 on January 1, 1986 (born on or before January 1, 1936), you may choose to treat a portion of the taxable part of a lump-sum distribution as a long-term capital gain taxable at a 20% (.20) rate. This treatment applies to the portion you receive for the employee's participation in the plan before 1974. A recipient may make only one choice with regard to an employee. Use Form 4972, *Tax on Lump-Sum Distributions,* to make this choice.

If you were not at least age 50 on January 1, 1986, the part you may treat as capital gain will be phased out between 1988 and 1991, and the treatment will be unavailable after 1991. (95% of the capital gain is eligible for this capital gain treatment for 1988.) Also, the 20% rate in the preceding paragraph does not apply and the capital gain is reported on Schedule D (Form 1040).

Special averaging method. For lump-sum distributions, you may elect special averaging of the ordinary income portion of the distribution. (This includes the capital gain portion of the distribution if you do not choose capital gain treatment for it.) For distributions received after 1986, you must have reached age 59½ and elect to use special averaging on all lump-sum distributions received in the tax year. (If you were born on or before January 1, 1936, the age 59½ requirement does not apply.)

If you receive the distribution for your own participation in the retirement plan, you must, to use this method, have been a participant in the plan for 5 or more years. You may only make one lifetime election to use this method with regard to any employee.

For distributions received after 1986, you figure your tax, using Form 4972, generally as though the distribution were received over 5 years.

If you were born on or before January 1, 1936, you may choose to use 10-year averaging instead of 5-year averaging. However, if you use 10-year averaging, you must use the tax rates in effect for 1986.

Form 1099–R. If you receive a total distribution from a plan, you should receive a Form 1099–R, *Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.* The Form 1099–R shows if a distribution qualifies as a lump-sum distribution. If the distribution qualifies, box 3 shows the capital gain and box 2 minus box 3 is the ordinary income. If you do not get a Form 1099–R, or if you have questions about it, contact your plan administrator.

Rollovers. Generally, a rollover is a tax-free transfer of cash or other assets from a qualified (IRS approved) retirement plan to an ***eligible retirement plan*** (defined below).

If you receive 50% or more of the balance to your credit in your employer's qualified plan, you may qualify to roll over the otherwise taxable part of this distribution to another retirement program and not pay tax on this amount to the extent it was rolled over. The amount you roll over, however, is generally taxable later when the recipient of the rollover pays that amount to you or your survivor.

You must complete the rollover by the 60th day following the day on which you receive the distribution. (This 60-day period is extended for any time the amount distributed is in a frozen deposit in a financial institution.) For all rollovers to an individual retirement arrangement (IRA), you must, by written notice to the trustee or issuer of the IRA, irrevocably elect rollover treatment.

In general, the most you can roll over is the part that, but for the rollover, would be taxable. From a total distribution, the most you can roll over is the fair market value of all the property you receive, minus any employee contributions you made to the plan (other than accumulated deductible employee contributions).

An eligible retirement plan is an IRA, a qualified employee retirement plan, or a qualified annuity plan. Partial distributions (less than the entire balance to your credit in the plan) may be rolled over only to an IRA.

More information. Since the rules on rollovers are complex, please get Publication 575 for details.

Deductible voluntary employee contributions. If you receive a distribution from your employer's qualified plan of part of the balance of your accumulated deductible voluntary contributions, you can roll over tax free any part of this distribution. The rollover can be either to an IRA or to certain other qualified plans.

Distributions you get as the beneficiary of a deceased employee may be accrued salary payments, distributions from employee profit-sharing, pension, annuity, and stock bonus plans, or other items that should be treated separately for tax purposes. How you treat these distributions depends on what is included in them.

Salaries or wages paid after the death of the employee are usually ordinary income to you, the beneficiary.

If the employee died while still employed, and the employee made contributions to a profit-sharing, pension, annuity, or stock bonus plan, you, as the beneficiary, use the General Rule, the Simplified General Rule, or the Three-Year Rule to figure the taxable amount. The deceased employee's contributions to the plan and the death benefit exclusion, if applicable, are your cost.

A surviving spouse who, as the beneficiary, receives a lump-sum distribution from a qualified profit-sharing, pension, annuity, or stock bonus plan may qualify to make a tax-free rollover of all or part of the taxable portion of the distribution to an IRA. See Publications 575 and 590 for more information about rollovers.

Under certain conditions, you also may be eligible for an employee's death benefit exclusion of up to $5,000. See *Death Benefit Exclusion,* earlier.

Employee's life insurance proceeds paid in a lump sum under an insurance contract upon the death of an employee usually are not taxable. However, any amounts you received that are larger than the face amount of the life insurance are taxable to the extent of the excess. Life insurance proceeds are discussed in Chapter 13.

Bond Purchase Plans

The Department of the Treasury stopped issuing U.S. Retirement Plan Bonds after April 30, 1982. They were a special series of interest-bearing bonds that retirement plans could buy.

A participant in a plan that bought retirement bonds may cash them at any time. A beneficiary may cash them after the participant's death. Interest on the bonds stops 5 years after the owner of the bonds dies. They may be cashed at any Federal Reserve Bank branch or at the office of the Treasurer of the United States.

If a retirement bond is distributed from a bond purchase plan to you as an employee or beneficiary and you cash in the bond, you are taxed on the amount received minus your cost (normally, any voluntary nondeductible employee payments used to buy that bond). However, you may defer the tax on the amount received by rolling it over to an IRA as discussed under *Rollovers* in Chapter 20. You may also roll it over to a qualified employer plan (but later distributions of the rollover amount do not qualify for 5– or 10–year averaging or capital gain treatment).

Tax on Early Distributions

Most distributions from qualified retirement plans made to employees before they reach age 59½ are subject to an additional tax of 10% on the part of the distribution that is includible in gross income.

For this purpose, a qualified retirement plan means:

1) A qualified employee retirement plan,
2) A qualified annuity plan,
3) A tax-sheltered annuity plan for employees of public schools or tax-exempt organizations, or
4) An individual retirement arrangement (IRA).

Exceptions to tax. The additional tax does not apply to distributions that are:

1) Made to a beneficiary or to the estate of the participant on or after his or her death,
2) Made because the participant is totally and permanently disabled,
3) Made as part of a series of substantially equal periodic (at least annual) payments over the participant's life expectancy or the joint life expectancy of the participant and his or her beneficiary,
4) Made to an employee who separated from service in or after the year in which he or she reached age 55,
5) Paid in connection with certain employee stock ownership plans (ESOPs),
6) Paid to the employee, to the extent the employee has deductible expenses for medical care (whether or not the employee itemizes deductions for the tax year),
7) Paid to alternate payees under qualified domestic relations orders, or
8) Made to an employee who, as of March 1, 1986, separated from service and began receiving benefits from the qualified plan under a written election designating a specific schedule of benefit payments.

The exception in (3) does not apply to distributions from plans ***other than*** IRAs, unless the payments begin after the employee's separation from service. The exceptions in (4), (5), and (6) do not apply to IRA distributions.

Tax on Excess Distributions

If retirement distributions in excess of $117,529 are made to you during calendar year 1988, you are subject to a 15% excise tax on the excess. The tax is offset by any 10% early withdrawal tax that applies to the excess distribution (see the preceding discussion). (The $117,529 amount will be adjusted for inflation in future years. It was $112,500 for 1987.)

Retirement distributions, for this purpose, include distributions from qualified employee retirement plans, qualified annuity plans, tax-sheltered annuities, and individual retirement arrangements (IRAs).

Excluded distributions. The following distributions are excluded from the tax:

- Distributions after death,
- Taxable distributions to an alternate payee under a qualified domestic relations order,
- Distributions attributable to the employee's investment in the contract, and
- Distributions to the extent rolled over tax free.

Combining distributions. If distributions for you are made to you and others, the distributions must be combined in figuring the amount of excess distributions for the year.

Lump-sum distributions. A different limit applies if you elect lump-sum distribution treatment (special averaging or capital gain treatment). In this case the $117,529 for 1988, which is subject to cost-of-living increases, is increased 5 times to $587,645. Then, this increased amount of $587,645 is applied to the lump-sum distribution separately for purposes of figuring the separate tax on the lump-sum distribution.

Benefit accruals as of August 1, 1986. You may choose, on a return filed for a tax year ending before 1989, to exclude from the tax a prorated part of the distribution that is related to your accrued benefits on August 1, 1986. However, this rule applies only if the accrued benefit as of August 1, 1986, exceeds $562,500. Otherwise, a limit of $150,000 applies (unless the limit otherwise figured is more than $150,000).

Tax for Failure to Make Minimum Distribution

Qualified pension, profit-sharing, and stock bonus plans (and, for benefits accruing after 1986, tax-sheltered annuity programs) must provide that distributions begin no later than April 1 of the year following the later of:

1) The calendar year in which the employee reaches age 70½, or
2) The calendar year in which the employee retires.

5% owners. Distributions to a 5% (or more) owner of the company maintaining the plan must begin by April 1 of the calendar year after the year in which he or she reaches age 70½, regardless of when he or she retires.

Distributions in years beginning after 1988. Generally, distributions in years beginning after 1988 must begin by April 1 of the year following the calendar year in which the employee reaches age 70½, without regard to the date of the employee's retirement. However, this rule will not apply to any individual (other than a 5% owner) who reaches age 70½ before 1988. Also, a later effective date for this rule may apply in the case of a plan maintained under a union-management agreement put into effect before March 1, 1986 (but the rule will be effective not later than plan years beginning after 1990).

Minimum distributions. The employee must either:

- Receive his or her entire interest in the plan by the required beginning date, as explained above, or
- Begin receiving regular partial distributions by that date in an amount large enough to use up the entire interest over the employee's life expectancy or over the joint life expectancies of the employee and a designated surviving beneficiary (or over a shorter period).

Additional information. For more information on this rule, including the life expectancy tables to use in figuring the minimum distributions, get Publication 575.

Tax on failure to distribute. For tax years beginning after 1988, if these required minimum distributions are not made, an excise tax is imposed on you, as the payee, equal to 50% of the amount required to be distributed, but not actually distributed, during the tax year. This excise tax may be waived if you establish that the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall.

The 50% excise tax will apply to distributions required to be made under any qualified retirement plan or eligible deferred compensation plan (including a tax-sheltered annuity of a tax-exempt organization or public school). It already applies to distributions from individual retirement arrangements. However, distributions from plans maintained under union-management agreements put into effect before March 1, 1986, generally will not be subject to the excise tax until plan years beginning after 1990.

Disability Income

Generally, if you retire on disability, you must report your pension or annuity as income.

If you were 65 or older at the end of the tax year, or you were under 65, retired on permanent and total disability, and you received taxable disability income, you may be able to claim the credit for the elderly or the disabled. See Chapter 34 for more information about the credit.

Taxable Disability Pensions or Annuities

Whether you must report your disability pension or annuity as income depends on how your pension plan is financed.

Generally, you must report as income any amount you receive for your disability through an accident or health insurance plan that is paid for by your employer. However, certain payments may not be taxable to you. These payments are discussed in Chapter 13.

If the plan does not say that you must pay a specific part of the cost of the disability pension, your employer is considered to provide the disability pension. You must report on your return all payments you receive.

If the plan says that you must pay a specific part of the cost of your disability pension, any amounts you receive that are due to your payments to the disability pension are not taxed. You do not report them on your return. They are treated as benefits received under an accident or health insurance policy that you bought. Except as otherwise provided, you must include in income the rest of the amounts you receive that are due to your employer's payments.

If you retired on disability during the past year, any lump-sum payment for accrued annual leave that you received when you retired is a salary payment. The payment is not a disability payment. You should report it as ordinary income in the year you received it.

If part of your disability pension is worker's compensation, that part is not taxed. If you die, the part of your survivor's benefit that represents a continuation of the worker's compensation is not taxed.

Your employer should be able to give you specific details about your pension plan and to tell you the amount, if any, you paid for your disability pension.

How to report. If you claim the credit for the elderly or the disabled, report all your taxable disability income on line 7, Form 1040, until you reach minimum retirement age. You cannot use Form 1040A or Form 1040EZ.

However, if you do not claim the credit for the elderly or for the disabled, you may use Form 1040A or Form 1040EZ. If you use one of these forms, report your disability income on line 7, Form 1040A, or line 1, Form 1040EZ.

If you retired on disability and had made contributions to the plan, payments you receive are taxable under the General Rule or Simplified General Rule (discussed earlier) beginning with the day after you reach minimum retirement age.

Minimum retirement age generally is the age at which you may first receive a pension or annuity whether or not you are disabled.

Military and Certain Government Disability Pensions

Generally, you must report disability pensions as income. But certain military and government disability pensions are not taxable. If your disability pension is taxable, you may be able to take the credit for the elderly or for the disabled. See Chapter 34 for more information about the credit.

Members of government services. Generally, you must report on your return any disability payments you receive for personal injuries or sickness resulting from active service in the armed forces of any country or in the National Oceanic and Atmospheric Administration, the Public Health Service, or the Foreign Service. However, if you receive a disability pension based on percentage of disability, you do not include the disability payments in your income if:

1) You were entitled to receive a disability payment before September 25, 1975, or
2) You were a member of a government service (or its reserve component), or were under a binding written commitment to become a member on September 24, 1975, or
3) You receive disability payments for a "combat-related injury," or
4) You would be entitled to receive disability compensation from the Veterans Administration if you filed an application for it.

Combat-related injury means personal injury or sickness that:

1) Directly results from armed conflict, or
2) Takes place while you are engaged in extra-hazardous service, or
3) Takes place under conditions simulating war, including training exercises such as maneuvers, or
4) Is caused by an instrumentality of war.

Disability based on years of service. If you receive a disability pension based on years of service, you generally must include it in your income. But if you fall into one of the four categories listed above under *Members of government services*, you do not include in income the part of your pension that you would have received if the pension had been based on percentage of disability. You must include the rest of your pension in income. If part of your disability pension is taxable, you may be able to take the credit for the elderly or for the disabled. See Chapter 34 for more information about the credit.

Terrorist attack. You do not include disability payments in income if you receive them for injuries directly resulting from a violent attack that occurred while you were a U.S. government employee performing official duties outside the United States. For your disability payments to be tax exempt, the Secretary of State must determine that the attack was a terrorist attack.

Disability benefits you receive from the Veterans Administration are not included in your gross income. If you are a military retiree and do not receive your disability benefits from the VA, you do not have to include in your income an amount of disability benefits equal to the VA benefits to which you are entitled.

If you retire from the armed services (based on years of service) and at a later date are given a retroactive service-connected disability rating by the VA, you do not include in income during the retroactive period the part of your retirement pay you would have been entitled to receive from the VA during that period. However, you must include in income any lump-sum readjustment payment you received on release from active duty, even though you are later given a retroactive disability rating by the VA.

Withholding of Tax

The payer of your pension, profit-sharing, stock bonus, annuity, or deferred compensation plan will withhold income tax on the taxable part of amounts paid to you unless you choose not to have tax withheld. You can make this choice by giving the payer a Form W–4P, *Withholding Certificate for Pension or Annuity Payments*, indicating that you do not want tax withheld. However, you cannot make this choice unless you provide the payer with your residence address in the United States. For more information, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*

Form W–4P may also be used to have tax withheld from periodic payments at the rate that applies to your filing status and number of exemptions. If you do not fill out Form W–4P, tax will be withheld from periodic payments as if you were married and claiming three withholding allowances. If tax is withheld, the amount will be shown on Form W–2P, *Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments.*

See Chapter 5 for more information about tax withholding.

Purchased Annuities

If you purchased an annuity contract from a commercial organization, such as an insurance company, a percentage of each payment you receive is not taxed. For more information, see Publication 575.

Sale of annuity. Gain on the sale of an annuity contract before its maturity date is ordinary income to the extent that the gain is due solely to interest accumulated on the contract.

Early withdrawal penalty. A penalty tax of 10% is imposed on amounts you withdraw from your deferred annuity contract before age 59½. For exceptions to this penalty, see Publication 575.

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12. Social Security and Equivalent Railroad Retirement Benefits

If you received social security or equivalent railroad retirement benefits in 1988, part of the amount you received may be taxable. This chapter discusses how to figure if any of your benefits are taxable and how to report any taxable benefits on your return. Also included are some examples that illustrate how the tax law applies to these benefits.

Note: **This chapter does not discuss the tax rules that apply to railroad retirement benefits other than the social security equivalent portion of tier 1 benefits (including special guaranty benefits). The tax rules that apply to the non-social security equivalent portion of tier 1 benefits, and to tier 2 benefits, vested dual benefits, and supplemental annuity benefits, are discussed in Chapter 11. Also see Publication 575, *Pension and Annuity Income.***

The tax rules discussed in this chapter do not apply to foreign social security benefits. Such benefits are taxable as a pension or annuity unless exempt from U.S. tax under a treaty. For example, social security benefits received by a U.S. citizen or resident from the Federal Republic of Germany or the United Kingdom are taxable under the tax rules discussed in Chapter 11.

Form SSA–1099. If you received or repaid social security benefits during 1988, you will receive Form SSA–1099, *Social Security Benefit Statement.* An IRS Notice 703 will be enclosed with your Form SSA–1099. This notice includes a worksheet you can use to determine if any of your benefits may be taxable. Keep this notice for your own records; do ***not*** mail it to either the IRS or the SSA.

Every person who received social security benefits will receive a Form SSA–1099, even if the benefit is combined with another person's in a single check. If you receive benefits on more than one social security record, you may get more than one Form SSA–1099.

Form RRB–1099. If you received or repaid the social security equivalent portion of tier 1 railroad retirement benefits or special guaranty benefits during 1988, you will receive Form RRB–1099, *Statement for Recipients of Payments by the Railroad Retirement Board.* Enclosed with your Form RRB–1099 will be a worksheet you can use to figure if any of your benefits may be taxable.

Each beneficiary will receive his or her own Form RRB–1099. If you receive benefits on more than one railroad retirement record, you may get more than one Form RRB–1099.

For more information about Form SSA–1099 and Form RRB–1099, including explanations of the items shown in each box on the forms, see Publication 915, *Social Security Benefits and Equivalent Railroad Retirement Benefits.*

Taxation of Benefits

In figuring if any of your benefits are taxable, use the amount shown in Box 5 of the Form SSA–1099 or Form RRB–1099 you received. If you received more than one form, add together the amount in Box 5 of each form.

Repayments. In figuring if any of your benefits are taxable, you must subtract any repayment of benefits you made during 1988 from the gross benefits you received in 1988. It does not matter if the repayment you made in 1988 was for a benefit you received before 1988. Your gross benefits are shown in Box 3 of the Form SSA–1099 or RRB–1099 you received, and your repayments are shown in Box 4. Box 5 shows your net benefits. (If the total of the amounts in Box 5 of all the forms you received is a negative figure, see *Repayments More Than Gross Benefits,* later.)

To whom taxable. Benefits, if taxable, must be included in the taxable income of the person who has the legal right to receive the benefits. For example, if you and your child receive benefits, but the check for your child is made out in your name, you must use only your portion of the benefits in figuring if any part is taxable to you. The portion of the benefits that belongs to your child must be added to your child's other income to see if any of those benefits are taxable.

Joint return. If you are married and file a joint return for 1988, you and your spouse must combine your incomes and your benefits when figuring if any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse's income to yours when figuring if any of your benefits are taxable.

Are Any of Your Benefits Taxable?

If the only income you received during 1988 was your social security or equivalent railroad retirement benefits, your benefits are not taxable and you probably do not have to file a return.

If you received income during 1988 in addition to social security or equivalent railroad retirement benefits, your benefits are generally not taxable if your income is not more than the following ***base amounts***:

- $25,000 if you are single.
- $25,000 if you are married, do not file a joint return and ***did not*** live with your spouse at any time during 1988.
- $32,000 if you are married and file a joint return.
- $-0- if you are married, do not file a joint return and ***did*** live with your spouse at any time during 1988.

You can use the worksheet in the following example, substituting your own amounts, to figure whether your income is more than the base amount for your filing status.

Example. You and your spouse are filing a joint return for 1988 and you both received social security benefits during the year. In January 1989, you received a Form SSA–1099 showing $6,600 in Box 5. Your spouse received a Form SSA–1099 showing $2,400 in Box 5. You also received a taxable pension of $10,000 and $500 in interest income during 1988. You did not have any tax-exempt interest in 1988. Your benefits are not taxable for 1988 because your income, as figured in the following worksheet, is not more than $32,000.

A	Write in the amount from ***Box 5*** of all your Forms SSA–1099 and RRB–1099. Include the full amount of any lump-sum benefit payments received in 1988, attributable to both 1988 and earlier years, if you choose to report the full amount for the 1988 tax year. (If you received more than one form, combine the amounts from Box 5 and write in the total.)	A	$ 9,000

Note: *If the amount on line A is zero or less, stop here; none of your benefits are taxable this year.*

B	Divide the amount on line A by 2 and write in the result	B	4,500
C	Add up your taxable pensions, wages, interest, dividends, and other taxable income and write in the total	C	10,500
D	Write in any tax-exempt interest, such as interest on municipal bonds	D	-0-
E	Add lines B, C, and D and write in the total	E	15,000

Note: *If the amount on line E is not more than the* ***base amount*** *for your filing status, none of your benefits are taxable this year.*

Figuring the Taxable Amount

Your social security or equivalent tier 1 benefits may be taxable, depending on the amount of your income and your filing status.

If you used Notice 703 or the worksheet included with your Form RRB–1099 and found that a portion of your benefits are taxable, you must figure the amount that is actually subject to tax. This is the ***lesser*** of:

1) One-half of the ***net benefits*** you received, or
2) One-half of the amount by which the sum of your ***modified AGI (adjusted gross income)*** plus one-half of your net benefits is more than the ***base amount*** for your filing status.

This means that the most that will be taxable is ***one-half*** of the net benefits you received.

Net benefits. This is the amount that is shown in Box 5 of Form SSA–1099 and Box 5 of Form RRB–1099. If you received more than one form, you must add the amounts in Box 5 of each form to get your total net benefits.

Modified adjusted gross income. This is the sum of your adjusted gross income plus any tax-exempt interest you received in 1988. Your adjusted gross income is figured without including any of your social security or equivalent railroad retirement benefits and without subtracting:

1) The foreign earned income exclusion and the foreign housing exclusion or deduction,
2) The exclusion of income from U.S. possessions, or
3) The exclusion of income from Puerto Rico by bona fide residents of Puerto Rico.

Form 1040EZ. If you usually file Form 1040EZ, figure modified adjusted gross income by adding:

Adjusted gross income (line 3, Form 1040EZ),
plus
Any tax-exempt interest received in 1988.

Form 1040A. If you usually file Form 1040A, figure modified adjusted gross income by adding:

Adjusted gross income (line 13, Form 1040A),
plus
Any tax-exempt interest received in 1988.

Note: If any of your benefits are taxable, you must use Form 1040—you cannot use Form 1040EZ or Form 1040A to report taxable benefits.

Form 1040. If you usually file Form 1040, leave line 21b, Form 1040, blank, and figure modified adjusted gross income by adding:

Adjusted gross income (line 31, Form 1040),
plus
Any foreign earned income exclusion, foreign housing exclusion or deduction, or exclusion of income from U.S. possessions or Puerto Rico,
plus
Any tax-exempt interest received in 1988.

Figuring your IRA deduction. If you make contributions to an individual retirement arrangement (IRA) in 1988, your allowable deduction for those contributions is subtracted from your gross income in arriving at your modified AGI. Therefore, you must figure your IRA deduction before you can figure your taxable social security and equivalent railroad retirement benefits.

If you or your spouse are covered by a retirement plan at work, your allowable IRA deduction may depend on the amount of your "modified AGI," which may include a tentative amount of taxable social security and equivalent railroad retirement benefits. Because those amounts are figured differently, ***do not*** use that "modified AGI" or tentative amount of taxable benefits when figuring the actual taxable amount of your social security and equivalent railroad retirement benefits.

See Publication 590, *Individual Retirement Arrangements (IRAs)*, for more information and worksheets that will help you in figuring your IRA deduction.

Tax-exempt interest. Even though you do not include tax-exempt interest in income, you must enter any tax-exempt interest you received on line 8b, Form 1040. You must add this interest to your adjusted gross income to arrive at your modified adjusted gross income. Interest you receive from municipal bonds and tax-exempt interest distributions you receive from mutual funds are examples of tax-exempt interest.

The base amount that applies is:

- $25,000 if you are single.
- $25,000 if you are married, do not file a joint return and ***did not*** live with your spouse at any time during 1988.
- $32,000 if you are married and file a joint return.
- $-0- if you are married, do not file a joint return and ***did*** live with your spouse at any time during 1988.

Lump-sum benefits. If you received a lump-sum (or retroactive) payment of social security or equivalent railroad retirement benefits during 1988 that is for benefits you should have received before 1988, it will be included in Box 3 of your Form SSA-1099 or Form RRB-1099. Box 3 will not include benefits you received in 1988 that were for months before December 1983, because they are not taxable.

Special election. Generally, you include a lump-sum benefit payment in total benefits for the year in which you receive it. However, if you receive a lump-sum benefit payment attributable to an earlier year (or years), you may elect to spread back the payment to the earlier year(s) and include in gross income for the current year only the sum of the increases in gross income for the current and earlier years that would have occurred if you had actually received the payment in the earlier years.

For more information on lump-sum benefits, see Publication 915.

Estimated tax. Because tax is not withheld from social security benefits or equivalent railroad retirement benefits, you may have to make estimated tax payments during the year. See Chapter 5 for more information on estimated tax.

How to Report

To help you figure your taxable benefits use the worksheet in the Form 1040 instruction package. Publication 915 also has a worksheet (Worksheet #1) you may use. However, if you take the foreign earned income exclusion, the foreign housing exclusion or deduction, the exclusion of income from U.S. possessions, or the exclusion of income from Puerto Rico by bona fide residents of Puerto Rico, you ***must*** use Worksheet #1 in Publication 915.

Lump-sum payment. If you received a lump-sum benefit payment in 1988 that is attributable to 1988 and an earlier year (or years) and choose to treat the payment as if it were received in those years, you ***must*** use the worksheets in Publication 915. Otherwise, you should treat the amount as if it were fully attributable to 1988 and include it in your total benefits received during that year.

Which form to use. If any of your benefits are taxable, you must use Form 1040 to report the taxable part. You ***cannot*** use Form 1040A or Form 1040EZ. Report your net benefits (the amount in Box 5 of your Form SSA-1099 or RRB-1099) on line 21a, Form 1040. Report the taxable part (from the last line of the worksheet) on line 21b, Form 1040.

Examples

Following are a few examples you can use as a guide in figuring if any of your benefits are taxable.

Example 1. George White is single and usually files Form 1040. During 1988, he received the following income:

Fully taxable pension	$18,600
Wages from part-time job	9,400
Interest income	990
Total	$28,990

George also received social security benefits during 1988. The Form SSA-1099 he received in January 1989 shows $7,200 in Box 3, $1,220 in Box 4, and $5,980 in Box 5. To figure his taxable benefits, George completes the worksheet shown here. A similar worksheet appears in the Form 1040 tax instructions.

Social Security and Equivalent Railroad Retirement Benefits Worksheet
(Keep for your records)

Check only one box

☑ **A.** Single—enter $25,000 on line 7 below.

☐ **B.** Married filing a joint return—enter $32,000 on line 7 below.

☐ **C.** Married not filing a joint return and lived with your spouse at any time during the year—enter -0- on line 7 below.

☐ **D.** Married not filing a joint return and **DID NOT** live with your spouse at any time during the year—enter $25,000 on line 7 below.

1. Enter the total amount from **Box 5** of **ALL** your **Forms SSA-1099 and Forms RRB-1099** (if applicable) 5,980

Note: *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 2.*

2. Divide the amount on line 1 by 2 2,990
3. Add the amounts on Form 1040, lines 7, 8a, 8b through 20, plus line 22. Do not include here any amounts from lines 16a or 17a of Form 1040, or from Box 5 of Forms SSA-1099 or RRB-1099 28,990
4. Add lines 2 and 3 31,980
5. Enter the amount from Form 1040, line 30 .... -0-
6. Subtract line 5 from line 4 31,980
7. Enter:
   $25,000 if you checked Box **A** or **D**, or
   $32,000 if you checked Box **B**, or
   -0- if you checked Box **C** 25,000
8. Subtract line 7 from line 6. Enter the result, but not less than zero 6,980

Note: *If line 8 is zero, stop here. None of your benefits are taxable. Do not enter any amounts on Form 1040, lines 21a or 21b, unless you checked Box D above. If you checked Box D, enter -0- on line 21b and write "D" on the dotted line to the left of line 21b. If line 8 is more than zero, go on to line 9.*

9. Divide the amount on line 8 by 2 3,490
10. **Taxable social security benefits.**
    - First, enter on Form 1040, line 21a, the amount from line 1 above.
    - Then, compare amounts on lines 2 and 9 above, and enter the **smaller** of the two amounts on this line and also on Form 1040, line 21b 2,990

The amount on line 10 of George's worksheet shows that $2,990 of his social security benefits are taxable. On line 21a of his Form 1040, George enters his net benefits of $5,980. On line 21b, he enters his taxable part of $2,990.

Example 2. Joe and Betty Johnson are married and are filing a joint return for 1988. Joe is retired and receives a fully taxable pension of $28,000. Joe and Betty both received social security benefits in 1988. Joe's Form SSA-1099 shows $6,600 in Box 3, $1,100 in Box 4, and $5,500 in Box 5. Betty's Form SSA-1099 shows $3,500 in Box 3 and the same amount in Box 5. The only other income Joe and Betty had in 1988 was $2,400 in interest income. They figure their taxable social security benefits by completing the worksheet shown below. They enter $9,000 on line 21a, Form 1040, and $1,450 on line 21b, Form 1040.

Social Security and Equivalent Railroad Retirement Benefits Worksheet
(Keep for your records)

Check only one box.

☐ **A.** Single—enter $25,000 on line 7 below.

☑ **B.** Married filing a joint return—enter $32,000 on line 7 below.

☐ **C.** Married not filing a joint return and lived with your spouse at any time during the year—enter -0- on line 7 below.

☐ **D.** Married not filing a joint return and **DID NOT** live with your spouse at any time during the year—enter $25,000 on line 7 below.

1. Enter the total amount from **Box 5** of **ALL** your **Forms SSA-1099 and Forms RRB-1099** (if applicable) 9,000

Note: *If line 1 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 2.*

2. Divide the amount on line 1 by 2 4,500
3. Add the amounts on Form 1040, lines 7, 8a, 8b through 20, plus line 22. Do not include here any amounts from lines 16a or 17a of Form 1040, or from Box 5 of Forms SSA-1099 or RRB-1099 30,400
4. Add lines 2 and 3 34,900
5. Enter the amount from Form 1040, line 30 .... -0-
6. Subtract line 5 from line 4 34,900

7. Enter:

$25,000 if you checked Box **A** or **D**, or
$32,000 if you checked Box **B**, or
-0- if you checked Box **C** 32,000

8. Subtract line 7 from line 6. Enter the result, but not less than zero 2,900

Note: *If line 8 is zero, stop here. None of your benefits are taxable. Do not enter any amounts on Form 1040, lines 21a or 21b, unless you checked Box D above. If your checked Box D, enter -0- on line 21b and write "D" on the dotted line to the left of line 21b. If line 8 is more than zero, go on to line 9.*

9. Divide the amount on line 8 by 2 1,450

10. **Taxable social security benefits.**
- First, enter on Form 1040, line 21a, the amount from line 1 above.
- Then, compare amounts on lines 2 and 9 above, and enter the **smaller** of the two amounts on this line and also on Form 1040, line 21b 1,450

Repayments More Than Gross Benefits

In some situations, your Form SSA-1099 or Form RRB-1099 will show that the total amount of benefits you repaid (Box 4) is more than the gross benefits (Box 3) you received. If this occurred, the amount in Box 5 will be a negative figure and none of your benefits will be taxable. If you receive more than one form, a negative figure in Box 5 of one form is used to offset a positive figure in Box 5 of another form. If you have any questions about this negative figure, contact your local Social Security Administration office or your local Railroad Retirement Board field office.

Joint return. If you and your spouse file a joint return, and your Forms SSA-1099 or Forms RRB-1099 show that your repayments are more than your gross benefits, but your spouse's are not, subtract the amount in Box 5 of your form from the amount in Box 5 of your spouse's form when figuring if your combined benefits are taxable.

Example. John and Mary are married and file a joint return for 1988. John received Form SSA-1099 showing $3,000 in Box 5. Mary also received Form SSA-1099 and the amount in Box 5 was ($500). John and Mary will use $2,500 ($3,000 minus $500) as the amount of their net social security benefits when figuring if any of their combined benefits are taxable.

Repayment of benefits received in an earlier year. If the sum of the amount shown in Box 5 of all of your Forms SSA-1099 and Forms RRB-1099 is a negative figure and all or a portion of this negative figure is attributable to benefits you included in gross income in 1984, 1985, 1986, and/or 1987, you may take an itemized deduction for the amount of the negative figure that represents those benefits. This deduction, if $3,000 or less, is subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions.

If this deduction is more than $3,000, you should figure your tax two ways:

1) Figure your tax for 1988 with the itemized deduction. This deduction is ***not*** subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions.
2) Figure your tax for 1988 without the deduction. If a portion of the negative figure represents a repayment of 1984 benefits, you must first recompute your 1984 tax, reducing your 1984 social security benefits by that portion. Recompute your 1985, 1986, and 1987 tax in the same manner, using any portion of the negative figure that represents a repayment of 1985, 1986, and 1987 benefits. Reduce your 1988 tax, figured without the deduction, by the total decrease in your 1984, 1985, 1986, and/or 1987 tax as recomputed.

Compare the tax figured in methods (1) and (2). Your tax for 1988 is the lesser of the two amounts. If method (1) results in less tax, take the itemized deduction on Schedule A (Form 1040). If method (2) results in less tax, claim a credit for the applicable amount on line 60 of Form 1040 and write "I.R.C. 1341" in the margin to the left of line 60. If both methods produce the same tax, deduct the repayment in full on Schedule A.

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13. Other Income

You must include in your gross income all income you receive in the form of money, property, and services that is not exempt from tax. This chapter discusses many items of taxable income, as well as some major items that are not taxable.

Miscellaneous Taxable Income

This section begins with brief discussions on numerous income items, arranged in alphabetical order. These discussions are followed by other taxable income items which are discussed in greater detail as follows:

Bartering
Partnership Income
S Corporation Income
Recoveries (including state income tax refunds)
Repayments
Royalties

Activity not for profit. You must include on your return income from an activity not for profit. An example of this type of activity would be a hobby or a farm you operate mostly for recreation and pleasure. Deductions for expenses related to the activity are limited, may not total more than the income you report, and may be taken only if you itemize deductions on Schedule A (Form 1040).

The activity will be presumed to have been for profit if it results in a profit in at least 3 out of 5 consecutive tax years. However, for the breeding, training, showing, or racing of horses, the activity must result in a profit in at least 2 out of 7 consecutive tax years. If the activity meets this test, it is presumed to be carried on for profit and the limits will not apply.

If you have engaged in an activity for less than 3 years, you may postpone the determination that the activity is not for profit by filing Form 5213, *Election To Postpone Determination as To Whether the Presumption That an Activity Is Engaged in for Profit Applies.* See Publication 535, *Business Expenses*, for more information.

Alaska oil royalties. If you were a resident of Alaska and qualified to receive a payment from Alaska's mineral income fund, you must report this amount on line 22, Form 1040. The state of Alaska will send you a Form 1099-MISC which shows this amount. IRS will also receive a copy of the Form 1099.

Alimony. Include in income on line 11, Form 1040, any alimony payments you receive. Amounts you receive for child support are not income to you. Alimony and child support payments are discussed in Chapter 21.

Allowances and reimbursements. If you receive travel, transportation, or other allowances or reimbursements from your employer, see Chapter 19.

Cancelled debt. A cancelled debt, or a debt paid for you by another person, generally is income to you and must be reported on line 22, Form 1040. A discount offered by a financial institution for the prepayment of a mortgage loan is income from the cancellation of a debt. However, you have no income from the cancellation of a debt if the cancellation, or the payment by another person, is intended by the other person as a gift to you.

If your debt is cancelled in a bankruptcy case (title 11) or when you are insolvent, the discharge of debt generally is not income. See Publication 908, *Bankruptcy and Other Debt Cancellation.*

Cancellation of student loan. You do not have income if your student loan is cancelled because you agreed to certain conditions to obtain the loan and then performed the services required. Under the terms of the loan you must be required to work for a specified period of time in certain professions for one of a broad class of employers. To qualify, the loan must have been made by:

1) The government—federal, state, or local, or an instrumentality, agency, or subdivision thereof,
2) A tax-exempt public benefit corporation which has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or
3) An educational organization under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan.

Cancellations of student loans under section 465 of the Higher Education Act of 1965 also are not income.

Court awards and damages. To determine if amounts you receive by settlement, compromise, or judgment must be included in income, you must consider the item which the settlement replaces. Include the following as ordinary income:

1) Interest on any award,
2) Compensation for lost wages or lost profits,
3) Punitive damages,
4) Amounts received in settlement of pension rights (if you did not contribute to the plan), or

5) Damages for:
    a) Patent or copyright infringement,
    b) Breach of contract, or
    c) Interference with business operations.

Do not include as income compensatory damages for the following:

1) Personal injury or sickness (whether received in a lump sum or installments),
2) Damage to your character,
3) Alienation of affection, or
4) Surrender of custody of a minor child.

See Publication 525, *Taxable and Nontaxable Income*, for additional information.

Estate and trust income. An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you are taxed on your share of its income. However, there is never a double tax. Estates and trusts file their returns on Form 1041 and report your share of the income on Schedule K–1 of Form 1041.

Current income required to be distributed. If you are the beneficiary of a trust that must distribute currently all of its income, you must report your share of the distributable net income whether or not you have actually received it.

Current income not required to be distributed. If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or a part of the current income, you must report all income that is required to be distributed to you, whether or not it is actually distributed, plus all other amounts actually paid or credited to you, to the extent of your share of distributable net income.

How to report estate and trust income. Each item of income is treated the same for you as for the estate or trust. If it is dividend income for the trust, it is the same for you.

The fiduciary of the estate or trust should tell you the type of items making up your share of the estate or trust income and any credits you are allowed on your individual income tax return.

Losses of estates and trusts generally are not deductible by the beneficiaries.

Grantor trust. Income earned by a grantor trust is taxable to the grantor, not the beneficiary. This rule applies if the property put into the trust will revert (be returned) to the grantor or the grantor's spouse. Generally, for transfers after March 1, 1986, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property. For transfers in trust made before March 2, 1986, a trust was a grantor trust if it was expected that the property would revert to the grantor within 10 years.

Fees. Include all fees for your services in gross income. Examples of these fees are amounts you received for such services as:

1) A corporation director,
2) An executor or administrator of an estate,
3) A notary public,
4) A witness or a member of a jury, and
5) An election precinct official.

Free tour. A free tour you receive from a travel agency for organizing a group of tourists must be included in income on line 22, Form 1040, or on Schedule C (Form 1040) at the fair market value of the tour. You may not deduct your expenses in serving as the voluntary leader of the group at the group's request.

Gambling winnings. You must include your gambling winnings in your income on line 22, Form 1040. If you itemize your deductions on Schedule A (Form 1040), you may deduct gambling losses you had during the year, but only up to the amount of your winnings.

Winnings from lotteries and raffles are gambling winnings. You must include in income bonds, cars, houses, and other noncash prizes at their fair market value.

Note: If you win a state lottery prize payable in installments, you must include in your gross income the annual payments and amounts designated as "interest" on the unpaid installments.

Hobby losses. Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See *Activity not for profit*, earlier.

Example. If you collect stamps, coins, or other items as a hobby for recreation and pleasure, and you sell any of the items, your gain is taxable as a capital gain. (See Chapter 16.) However, if you sell items from your collection at a loss, you may not deduct a net loss.

Illegal income, such as stolen or embezzled funds, must be included in gross income on line 22, Form 1040, or on Schedule C (Form 1040).

Investment clubs. An investment club is a group of friends, neighbors, business associates, or others who pool limited or stated amounts of funds to invest in stock or other securities. The club may or may not have a written agreement, charter, or by-laws. Usually the group operates informally with members pledging a regular amount to be paid into the club monthly. Some clubs have a committee that gathers information on securities, selects the most promising, and recommends that the club invest in them. Other clubs rotate the investigatory responsibilities among all their members. Most require all members to vote for or against all investments, sales, exchanges, or other transactions.

Most clubs operate as partnerships and are treated as such for federal tax purposes. Others operate as corporations, trusts, or associations taxed as corporations.

For information about the tax requirements of an investment club, see Publication 550, *Investment Income and Expenses.*

Kickbacks. You must include in income on line 22, Form 1040, or on Schedule C (Form 1040), kickbacks, side commissions, push money, or similar payments you receive.

Example. You are a car salesperson and help arrange car insurance for buyers. Insurance brokers kick back part of their commissions to you for referring customers to them. You must include the kickbacks in your income.

Note received for services. If your employer gives you a note as payment for your services, you must include the fair market value (usually the discount value) of the note in your income as wages for the year you receive it. When you later receive payments on the note, part of each payment is a recovery of the fair market value that you previously included in income. Do not again include that part in your income. Include the rest of the payment in your income in the year of payment.

Prizes and awards. If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in income. For example, if you win a $50 prize in a photography contest, you must report this income on line 22, Form 1040.

Employee cash awards or bonuses. Cash awards or bonuses given to you by your employer for good work or suggestions must be included in your income. However, certain employee awards are excludable from income. See Chapter 6.

Prizes and awards in goods or services must be included in income at their fair market value. If you refuse to accept a prize, you do not include it in your income.

Pulitzer, Nobel, and other prizes awarded in recognition of past accomplishments—in religious, charitable, scientific, artistic, educational, literary, or civic fields—are not included in income if ***all*** of the following requirements are met:

1) You were selected without any action on your part to enter the contest or proceeding,
2) You are not required to perform substantial future services as a condition to receiving the prize or award, and
3) The prize or award is transferred directly to a governmental unit or tax-exempt charitable organization as designated by you.

Property purchased from employer. If you bought shares of stock or other property from your employer for less than fair market value, you ordinarily must include in income as wages, the difference between their fair market value at the time you bought them and the amount you paid. You also must include in income the fair market value of any stock you received free from your employer. See *Property received for services* in Chapter 6.

Sale of personal items. If you sell an item that you owned for personal use, such as a car, refrigerator, furniture, hi-fi, jewelry, or silverware, a gain is taxable as a capital gain reported on Schedule D (Form 1040). A loss is not deductible.

However, if you sell an item that you held for investment, such as gold or silver bullion, coins, or gems, a gain is taxable as a capital gain and a loss is deductible as a capital loss.

Bartering

Bartering is an exchange of property or services.

Fair market value. You must include in income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Example 1. You are a self-employed attorney and perform legal services for a client, a small corporation. In payment for your services, you receive shares of stock in the corporation. You must include in income on Schedule C (Form 1040) the fair market value of the shares in the year that you receive them.

Example 2. You are a self-employed accountant. Both you and a housepainter are members of a barter club. The organization each year gives its members a directory of members and the services each member provides. Members get in touch with each other directly and bargain for the value of the services to be performed. In return for accounting services you provided, the housepainter painted your home. You must report as income on Schedule C (Form 1040) the fair market value of the housepainting services you received, and the housepainter must include in income the fair market value of the accounting services you provided.

Example 3. You are a member of a barter club. The club uses "credit units" as a means of exchange. It adds credit units to your account for goods or services you provide to other members, and it subtracts credit units from your account for goods or services you receive from other members. You must include in your income the value of credit units that are added to your account, even though you do not actually receive goods or services from other members until a later tax year.

Example 4. You own an apartment building and you received a work of art created by an artist in return for the artist's rent-free use of an apartment for six months. You must report as rental income on Schedule E (Form 1040) the fair market value of the art work, and the artist must report as income on Schedule C (Form 1040) the fair rental value of the apartment.

Barter exchange. If you exchanged property or services through a barter exchange, you will probably receive a statement from the barter exchange (Form 1099–B, *Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions*, or a similar statement). You should receive the statement by January 31, 1989, and it will generally show the value of cash, property, services, credits, or scrip you received from exchanges during the year. The Internal Revenue Service will also get a copy of Form 1099–B.

Backup withholding. The income you receive from bartering is generally not subject to withholding. However, backup withholding will apply in certain circumstances to ensure that income tax is collected on this income.

If you join a barter exchange, you must certify under penalties of perjury that your social security or employer identification number is correct and that you are not subject to backup withholding. If you do not make this certification, backup withholding may begin immediately. The barter exchange will give you a Form W–9, *Request for Taxpayer Identification Number and Certification*, or a similar form, for you to make this certification. For information on backup withholding, see Chapter 5.

Reporting the tax withheld. If tax is withheld from your barter income, the barter exchange must give you a Form 1099–B, or similar statement, that indicates the amount of tax withheld.

Partnership Income

A partnership is not a taxable entity. The income, gains, losses, credits, and deductions of a partnership are "passed through" to the partners based on each partner's distributive share of these items.

Partner's distributive share. Your distributive share of partnership income, gain, loss, deduction, or credit is your share of these items of the partnership, based on the partnership agreement, whether or not they are actually distributed to you. However, your distributive share of the partnership losses is limited to the adjusted basis of your interest in the partnership at the end of the partnership year in which the losses took place.

The partnership agreement usually covers the distribution of profits, losses, and other items. However, if there is no agreement for sharing a specific item of gain or loss, generally each partner's distributive share is figured according to the partner's interest in the partnership.

The partnership return. Although a partnership pays no tax, it must file a return on Form 1065. This shows the results of the partnership's operations for its tax year and the items that must be "passed through" to the partners.

Partner's return. You are required to treat partnership items the same way on your individual return that they are treated on the partnership return. That is, if the partnership had a capital gain, you report your share on your Schedule D (Form 1040). You report your share of partnership ordinary income on Schedule E (Form 1040).

Schedule K-1 (Form 1065). You should receive from each partnership in which you are a partner, a copy of the *Partner's Instructions for Schedule K-1 (Form 1065)*, together with a copy of Schedule K-1 (Form 1065) showing your share of income, credits, deductions, and tax preference items of the partnership for the tax year. Retain Schedule K-1 of Form 1065 for your records. Do not attach it to your Form 1040.

For an example of how to report partnership items, see Chapter 38.

For more information on partnerships, see Publication 541, *Tax Information on Partnerships*.

S Corporation Income

In general, an S corporation does not pay tax on its income. Instead, the income and expenses of the corporation are "passed through" to the shareholders.

S corporation return. An S corporation generally does not pay tax, but it must file a return on Form 1120S. This shows the results of the corporation's operations for its tax year and the items of income, gain, loss, deduction, or credit that affect the shareholders' individual income tax returns.

Shareholder's return. Generally, S corporation distributions are a nontaxable return of your basis in the corporation's stock. However, in certain cases, part of the distributions may be taxable as a dividend, or as a long-term or short-term capital gain, or as both. The corporation's distributions may be in the form of cash or property.

All current year income or loss and other tax items are taxed to you at the corporation's year end. Generally, these items passed through to you as a shareholder will increase or decrease the basis of your S corporation stock as appropriate. Dividends are only paid from prior year earnings (generally retained earnings from years prior to 1983 or prior to becoming an S corporation). Generally, property (including cash) distributions, except dividend distributions, are considered a return of capital to the extent of your basis in the stock of the corporation. Distributions in excess of basis are treated as a gain from the sale or exchange of property.

You should receive from the S corporation in which you are a shareholder a copy of the *Shareholder's Instructions for Schedule K-1 (Form 1120S)*, together with a copy of Schedule K-1 (Form 1120S) showing your share of the income, credits, and deductions of the S corporation for the tax year. Your distributive share of the items of income, gain, loss, deduction, or credit of the S corporation must be shown separately on your Form 1040. The character of these items generally is the same as if you had realized or incurred them personally.

For more information on S corporations and their shareholders, see Publication 589, *Tax Information on S Corporations*.

Recoveries

A recovery is a return of an amount you deducted or took a credit for in a prior year. Generally, you must include part or all of the recovered amounts in income in the year the recovery is received. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). Non-itemized deduction recoveries include such items as payments you receive on previously deducted bad debts, reimbursements not included on your Form W-2 for an employee business expense deducted before 1987, and recoveries on items for which you previously claimed a tax credit.

If you receive recoveries from items that were deducted in two or more years, the amount of the recoveries to include in income must be figured separately for each year.

Interest on any of the amounts you recover must be reported as interest income in the year received.

Recovery and expense same year. If the refund or other recovery and the deductible expense occur in the same year, the refund or recovery reduces the deduction and is not reported as income.

Refunds of federal income taxes are not included in income because they are never allowed as a deduction from income.

Recovery attributable to 2 or more years. If you receive a refund or other recovery from one item, such as a real estate tax rebate, that is attributable to amounts you paid in two or more separate years, you must allocate, on a pro rata basis, the amount recovered between the years in which it was paid.

This allocation is necessary to determine the amount of recovery attributable to any prior years and to determine the amount, if any, of your allowable deduction for this item for the current year. For information on how to compute the allocation, see *Recoveries* in Publication 525, *Taxable and Nontaxable Income*.

Tax benefit rule. If you did not derive a tax benefit from your prior year deduction, you do not have to include the amount you received this year in income. This could happen if you were subject to the alternative minimum tax or had credits that reduced your tax liability to zero. For more information, see Publication 525.

Itemized Deduction Recoveries

If you recover any amount that you deducted in a prior year on Schedule A (Form 1040), you must determine how much, if any, of the recovery to include in your income.

Due to changes in the tax law, different computations are needed for the recovery of items deducted after 1986 or before 1987. The discussions in this section apply to recoveries from any year, unless otherwise noted.

Standard deduction. To determine if amounts deducted in 1987 and recovered in 1988 must be included in income, you must know the standard deduction for your filing status in 1987. For information on the standard deduction, see Chapter 22.

Form 1099–G. If you received a state or local income tax refund in 1988, you may receive a statement, Form 1099–G, *Statement for Recipients of Certain Government Payments,* from the payer of the refund (or credit or offset) by January 31, 1989. The Internal Revenue Service will also receive a copy of the Form 1099–G.

No prior year deduction. If you did not itemize deductions in the year for which you received the recovery, you do not include any of the recovery amount in income.

Recovery limited to deduction. You do not include in income any amount of your recovery that exceeds the amount you deducted in the prior year. The amount you include in income is limited to the smaller of:

1) The amount deducted on Schedule A (Form 1040), or
2) The amount recovered.

Example. During 1987 you had $1,200 of medical expenses. From this amount you subtracted $1,000, which was 7.5% of your adjusted gross income. Your actual medical expense deduction was $200. In 1988, you received a $500 reimbursement from your medical insurance for your 1987 expenses. The only amount of the $500 reimbursement that may be considered as income in 1988 is $200—the amount actually deducted.

Total recoveries included in income. The total amount recovered in 1988 is included in income if certain requirements are met. These requirements are different for amounts deducted after 1986 and amounts deducted before 1987. The recoveries included in income will not be more than the amount deducted. See *Tax benefit rule,* earlier.

- Amounts deducted **after 1986** will be included in income if:
    a) The recoveries are equal to or less than the amount by which your itemized deductions exceeded the standard deduction for your filing status in the prior year, and
    b) Your taxable income in the prior year was -0- or more.
- Amounts deducted **before 1987** will be included in income if:
    a) The recoveries are equal to or less than the prior year's excess itemized deductions, and
    b) Your taxable income in the prior year was greater than your zero bracket amount.

Enter the amount of your state and local income tax refunds on line 10, Form 1040, and the total of all other recoveries as other income on line 22, Form 1040.

Example. In 1987, your taxable income was $16,000, the standard deduction for your filing status was $3,760, and you had itemized deductions of $5,760. In 1988, you received the following recoveries for amounts deducted in 1987:

Medical expenses	$200
State and local income tax refund	400
Real estate tax rebate	300
Interest expense	25
Total recoveries	$925

Because your total recoveries are less than the amount your itemized deductions exceeded the standard deduction ($5,760 −3,760 = $2,000), and your 1987 taxable income was $16,000, you must include your total recoveries in income in 1988. Report the state and local income tax refund of $400 on line 10, Form 1040, and the balance of your recoveries, $525, on line 22, Form 1040.

Total recoveries not included in income. The total recovery that must be included in income is limited to the amount by which your deductions reduced your tax (by any amount) in the prior year. (However, see *Tax benefit rule,* earlier.)

After 1986, you are generally allowed to claim the standard deduction if you do not itemize your deductions. Only your itemized deductions that are more than your standard deduction are subject to the recovery rule. Therefore, include in income the smaller of:

1) Your recoveries, or
2) The amount by which your itemized deductions exceeded the standard deduction.

Example. You filed a joint reutrn in 1987. Your itemized deductions were $5,760. The standard deduction that you could have claimed was $3,760. In 1988 you recover $2,400 of your 1987 itemized deductions. You include $2,000 of the recovery in your 1988 income. This is the smaller of your recoveries ($2,400) or the amount your itemized deductions exceeded the standard deduction ($5,760 − 3,760 = $2,000).

Before 1987. Because only excess itemized deductions before 1987 could reduce tax, your recoveries that must be included in income in 1988 cannot be greater than your excess itemized deductions.

The zero bracket amount allowed before 1987 was not taxed. Therefore, if your taxable income was zero or more, but less than your zero bracket amount, your excess itemized deductions were reduced by the difference between your zero bracket amount and your taxable income.

See *Recoveries* in Publication 525, *Taxable and Nontaxable Income,* if:

1) You recover in 1988 amounts deducted before 1987,
2) You had a negative taxable income in the prior year,
3) You have recoveries from items other than itemized deductions,
4) You were required to itemize deductions in the prior year for which you received the recovery,
5) You received a recovery for an item for which you claimed a tax credit (other than investment credit or foreign tax credit) in a prior year,
6) You were subject to the alternative minimum tax, or you had credits that reduced your tax liability to zero, in the year the deduction was claimed,
7) Your last payment of 1987 estimated state income tax was made in 1988, or
8) You were claimed as a dependent on another person's tax return in 1987.

Repayments

If you had to repay, during your tax year, an amount that you had included in income in an earlier year because at that time you thought you had an unrestricted right to it, you may deduct the amount you repaid from your income for this year.

Type of deduction. The type of deduction in the year of repayment depends on the type of income you included in the earlier year. For instance, if you repay an amount that you previously reported as a capital gain, deduct the repayment as a capital loss. If you repay advance commissions and other earnings, see Chapter 6.

Repayment $3,000 or less. If the amount you repaid was $3,000 or less, deduct it from your income on the same form or schedule on which you previously reported it. For example, if you reported it as a capital gain, deduct it on Schedule D (Form 1040). If you reported it as wages or other ordinary income, deduct it on line 25, Schedule A (Form 1040).

Repayment over $3,000. If the amount you repaid was more than $3,000, you figure your tax in two ways. Compare the results and your tax is the lesser amount:

1) Figure your tax for 1988 claiming a deduction for the repaid amount.
2) Figure your tax for 1988 ***without*** deducting the amount you repaid. Then,
    a) Refigure your tax from the earlier year without including the amount you repaid in 1988.
    b) Subtract the tax in (a) from the tax shown on your return for that year.
    c) Then subtract the answer in (b) from the tax for 1988 figured without the deduction.

How you treat the repayment on your 1988 return depends on which answer above results in less tax.

- If the answer in (1) is less tax, deduct the amount repaid on the same form or schedule on which you previously reported it.
- If the answer in (2) is less tax, claim a credit on line 60, Form 1040, and write "I.R.C. 1341" in the margin to the left of line 60.

An example of this computation may be found in Publication 525.

Royalties

Royalties from copyrights, patents, oil, gas, and mineral properties are taxable as ordinary income.

You generally report royalties on Part I, Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest, or are in business as a self-employed writer, inventor, artist, etc., report gross income and expenses on Schedule C (Form 1040).

Copyrights and patents. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

You may recover your cost or other basis through depreciation deductions over the life of the copyright or patent. If a patent or copyright becomes worthless in any year before it expires, you may deduct your unrecovered cost or other basis in the year it becomes worthless.

Your basis in the property includes all items that you must add to the basis of the work, such as stationery and other supplies, travel expenses to obtain material for a book, the cost of a working model of your invention, legal and other fees for the copyright or patent, etc.

Oil, gas, and minerals. Royalty income from oil, gas, and mineral properties is the amount you receive upon the extraction of natural resources from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you may recover your investment through the depletion allowance. For information on this subject, see Publication 535, *Business Expenses.*

Coal and iron ore. Under certain circumstances, you may treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income. These situations are discussed in Publication 544, *Sales and Other Dispositions of Assets.*

Interest in the property sold. If you sell your complete interest in the oil, gas, or mineral rights, the amount you receive is considered payment for the sale of your property, not royalty income. Under certain circumstances, the sale may be subject to capital gain or loss treatment on Schedule D (Form 1040). See Chapter 16.

Also, you may be allowed to report the sale as an installment sale if you are to receive at least one payment after the tax year in which the sale took place. See Publication 537, *Installment Sales.*

Part of future production sold. If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you should include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

Your payments for the buyer's share of the proceeds are treated as a loan repayment. The buyer will treat the share as a return of capital that is not included in income or subject to a depletion allowance. Any interest factor received by the buyer will be treated as ordinary income not subject to the allowance for depletion.

If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment is ordinary income subject to a depletion allowance.

Income Not Taxed

You generally should not report the following items on your return. Some of the items, however, are only partly excludable from income. A discussion of other totally or partly excludable items follows the list.

Accident and health insurance proceeds

"Black lung" benefits

Casualty insurance and other reimbursements (Chapter 27)

Child support payments (Chapter 21)

Employment agency fees (Chapter 30)

Federal Employees' Compensation Act payments

Government cost-of-living allowances (Chapter 6)

Interest on state or local government obligations (Chapter 8)

Meals and lodging (Chapter 6)

Members of the clergy housing allowance (Chapter 6)

Military allowances (Chapter 6)

Scholarships and fellowship grants

Social security benefits and equivalent railroad retirement benefits (Chapter 12)

Veterans' benefits (Chapter 6)

Workers' compensation and similar payments

Campaign contributions are not income to a candidate unless they are diverted to his or her personal use. To be exempt from tax, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains on sales of contributed securities are taxable and must be reported on Form 1120–POL, *U.S. Income Tax Return for Certain Political Organizations.* Excess campaign funds transferred to an office account must be included in the officeholder's income on line 22, Form 1040, in the year transferred.

Cash rebates. If you receive a cash rebate from a manufacturer or dealer on an item that you buy, it is not income.

Example. You buy a new car for $9,000 cash and receive a $400 rebate check from the manufacturer. The $400 is not income to you. Your cost is $8,600. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business.

Employee achievement awards. You may exclude from income employee achievement awards you receive only if they are deductible by your employer. To be deductible by your employer, and excludable by you, the awards must:

1) Be given for length of service or safety achievement,
2) Be tangible personal property,
3) Be given under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation,
4) Be given as part of a meaningful presentation, and
5) Not be more than the specified dollar limits.

Dollar limits. There are limits to the total awards you may exclude in one year. Awards from non-qualified plans are limited to $400, and total awards, from both qualified and non-qualified plans, are limited to $1,600. The cost to your employer is the determining factor for these limits. Amounts over the limits cannot be deducted by your employer and must be included in your income.

A qualified plan award is one you are awarded as part of an established written plan by your employer that does not discriminate in favor of highly compensated employees. An award will not be considered a qualified plan award if the average cost of all employee achievement awards given by your employer during the tax year is more than $400. In determining average cost, awards of nominal value are not taken into account.

Example. Ben Green received three employee achievement awards during 1988: a non-qualified plan award of a watch valued at $250, and two qualified plan awards of a stereo valued at $1,000 and a set of golf clubs valued at $500. Assuming that the requirements for qualified plan awards are otherwise satisfied, each award by itself would be excludable from income. However, since the total value of the awards is more than $1,600, Ben must include the excess of $150 ($1,750 – $1,600) in income.

Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. Add any amounts that you previously received under the contract and excluded from income to the lump-sum payment to find how much of the total is a return of your cost and how much is an excess over your cost. Include any excess over your cost in income.

Endowment proceeds that you choose to receive in installments instead of a lump-sum payment at the maturity of the policy are taxed as an annuity as explained in Publication 575, *Pension and Annuity Income.* For this treatment to apply, you must choose to receive the proceeds in installments before receiving any part of the lump sum, and within 60 days after the lump sum first may be paid to you.

Foster-care providers. Payments you receive from a state, political subdivision, or tax-exempt child-placement agency for providing foster-care to qualified individuals in your home are not included in income. You may not deduct the related expenses. However, you must include in income payments received for the care of more than 5 individuals age 19 and older.

A qualified foster individual is:

1) An individual living in a foster family home, and
2) Placed by,
    a) An agency of a state or one of its political subdivisions, or
    b) A tax-exempt child placement agency licensed by a state, if the individual is under age 19.

Difficulty of care payments are not included in income. These are additional payments made to foster-care providers of physically, mentally, or emotionally handicapped individuals by a state, political subdivision, or tax-exempt child-placement agency and are designated as difficulty of care payments. A state must determine the additional compensation is needed. You must include in income difficulty of care payments received for more than:

1) 10 children under age 19, and
2) 5 individuals age 19 and older.

Maintaining space in home. If you are paid by a placement agency to maintain space in your home for foster-care individuals, or if you receive payments that you must include in income, you are in business as a foster-care provider and you are self-employed. You must include these payments in income. You may deduct expenses that are related to these payments.

Report the income and expenses on Schedule C and net business income on Schedule SE (Form 1040).

See *Using Your Home in Your Work* in Chapter 30.

For more information on foster care, see Publication 501, *Exemptions, Standard Deduction, and Filing Information.*

Gifts and Inheritances. Property received as a gift, bequest, or inheritance is not included in your income. But if property you receive this way later produces income such as interest, dividends, or rentals, that income is taxable to you. If property is given to a trust and the income from it is paid, credited, or distributed to you, that also is income to you. If the gift, bequest, or inheritance is the income from the property, that income is taxable to you.

Gifts do not include items given to you as an incentive to enter into a business transaction. For example, items such as small appliances or dinnerware given to you by a bank as an incentive to make a deposit are interest income to you and must be reported at their fair market value.

Interest on frozen deposits. In general, you may exclude from income the amount of interest earned on a frozen deposit. A deposit is frozen if at the end of the calendar year you cannot withdraw any part of the deposit because:

1) The financial institution is bankrupt or insolvent, or
2) The state where the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

The amount of interest that you may exclude from gross income for the year is the interest that was credited on the frozen deposits for that tax year minus the sum of:

1) The net amount withdrawn from the deposit during that year, and
2) The amount that could have been withdrawn at the end of that tax year (not reduced by any penalty for premature withdrawals of a time deposit).

In the year the interest becomes withdrawable, you must include in income the part of the interest that was excluded.

Example. For tax year 1988, Bill and Joan Smith had interest income of $1,500 credited to their account. The account is with a bank that has been insolvent since 1985. The Smiths were not able to withdraw any money from this frozen account. They may exclude the $1,500 of interest credited to this account from their 1988 gross income.

Living expenses paid by insurance. Do not include in income amounts you receive under an insurance policy for additional living expenses you and your family had because you lost the use of your home by fire, storm, or other casualty. The amount you exclude from income is limited to your extra living expenses that are more than the normal expenses you would have had. Extra living expenses, for this purpose, include only those to keep you and your family at the same standard of living you had before the loss.

Sale of home. If you are 55 or older and sell or exchange your main home, you may choose to exclude from your income, under certain conditions, all or part of any gain from the sale or exchange. See Chapter 17.

Transporting schoolchildren. Do not include in income a school board mileage allowance for taking children to and from school if you are not in the business of taking children to school. You may not deduct expenses of providing this transportation.

Life Insurance Proceeds

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This applies even if the proceeds were paid under an accident or health insurance policy or an endowment contract.

Proceeds not received in installments. If death benefits are paid to you in a lump sum or other than at regular intervals, include them in your gross income only to the extent they are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include the benefit payments in income to the extent they are more than the present value of the payments at the time of death.

Proceeds received in installments. If you receive life insurance proceeds in installments, you may exclude part of each installment from your income.

To determine the excludable part, you must divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments that are to be paid. Include anything over this excludable part in income as interest. For more information, see Publication 525.

Surviving spouse. If your spouse died before October 23, 1986, and insurance proceeds are payable to you because of the death of your spouse, and you receive them in installments, you may exclude up to $1,000 a year of the interest included in the installments. This is in addition to the part of each installment that is excludable as a recovery of the lump sum payable at death. If you remarry, you may continue to take the exclusion.

If your spouse died after October 22, 1986, you may not exclude any interest payments included in the installment payments. See Chapter 8.

Interest option on insurance. If you leave proceeds from life insurance on deposit with an insurance company under an agreement to pay interest only, the interest paid to you is taxable.

If your spouse died before October 23, 1986, and you chose to receive only the interest from your insurance proceeds, the $1,000 interest exclusion for a surviving spouse does not apply. If you later decide to receive the proceeds from the policy in installments, you may take the interest exclusion from the time you begin to receive the installments.

Payments to beneficiaries of deceased employees (death benefit exclusion). The first $5,000 of payments, made by or for an employer because of an employee's death, may be excludable from the income of the beneficiaries. The payments need not be made as the result of a contract. The amount excluded for any deceased employee may not be more than $5,000 regardless of the number of employers or the number of beneficiaries.

This exclusion also covers payments of the balance to the credit of a deceased employee under a stock bonus, pension, or profit-sharing plan, as long as they are received during one tax year of the beneficiary.

Example. William Smith was an officer of a corporation at the time of his death last year. The board of directors voted to pay Mr. Smith's salary to his widow for the remainder of the year for his past services. During the year the corporation made payments of $18,000 to the widow. She may exclude from her income the first $5,000 she received, but must include the remaining $13,000 on line 22, Form 1040.

Self-employed individuals. The death benefit exclusion also applies to lump-sum distributions paid on behalf of self-employed individuals, if paid under a qualified pension, profit-sharing, or stock bonus plan.

Payments not qualifying. Any amount that the deceased employee (or self-employed individual) had a guaranteed right to receive had death not occurred cannot be excluded as a tax-free death benefit. If the deceased employee was receiving a retirement annuity, and the beneficiary continues to receive payments under a joint and survivor annuity option, these payments do not qualify for the death benefit exclusion. However, if the deceased employee had retired on disability and at the time of death had not reached minimum retirement age, payments to the beneficiary may qualify for the death benefit exclusion. Minimum retirement age generally is the age at which an individual may receive a pension or annuity whether or not that individual is disabled.

Death benefits paid in installments over a period of years are annuity payments. If you are the beneficiary of an employee who died while still employed, the pension or annuity you receive may qualify for a death benefit exclusion. This exclusion is limited to $5,000 and generally applies to the amount by which the present value of the annuity, figured as of the date of the employee's death, is more than the larger of:

1) The employee's contributions to the plan, or
2) The amount the employee had a guaranteed right to receive.

If you are eligible for the exclusion, add it to the cost or unrecovered cost of the annuity in figuring, at the annuity starting date, the investment in the contract.

Treatment of annuity payments to beneficiaries of employees and the death benefit exclusion are discussed in Chapter 11.

The death benefit exclusion does not apply to the interest on the proceeds of a life insurance policy payable to a surviving spouse because of the death of the other spouse. The interest is covered by a separate exclusion of

$1,000, but only if the spouse died before October 23, 1986. See *Proceeds received in installments,* earlier.

Interest on an employee's death benefit is fully taxable if the benefit is left on deposit under an agreement to pay interest only.

Plan treated as life insurance. Death benefits paid to employees' beneficiaries under certain plans involving risk shifting and risk distribution may qualify as life insurance proceeds. These benefits are not taxable unless the policy was turned over to the beneficiary for a price. They are not subject to the $5,000 exclusion limit.

Deceased public safety officers. If you are a surviving dependent of a public safety officer (law enforcement officer or firefighter) who died in the line of duty, do not include in your income the $50,000 death benefit payable to you. This applies to payments made by The Bureau of Justice Assistance.

Welfare and Other Public Assistance Benefits

Do not include in income the benefit payments from a public welfare fund, such as payments because of blindness. Payments from a state fund for the victims of crime, if they are in the nature of welfare payments, should not be included in the victims' incomes. Do not deduct medical expenses that are reimbursed by such a fund.

Payments for age and residency. If a state makes payments to its citizens who meet certain age and residency tests, and the payments are not based on need, the payments are not welfare benefits. Include them in gross income on line 22, Form 1040.

Handicapped persons employed in community service activities under the Employment Opportunities for Handicapped Individuals Act do not include in income the wages, allowances, or reimbursements paid to them under the Act.

Grants under the Disaster Relief Act of 1974 to help victims of natural disasters are not included in income. Do not deduct casualty losses or medical expenses that are specifically reimbursed by these disaster relief grants. Disaster unemployment assistance payments under the Act are unemployment benefits that are taxable. See *Unemployment compensation* in Chapter 6.

Mortgage assistance payments under section 235 of the National Housing Act are not included in the homeowner's gross income.

Interest paid for the homeowner under the mortgage assistance program is not deductible.

Payments to reduce cost of winter energy. Payments by a state to qualified people to reduce their cost of winter energy use are not taxable.

Other Sickness and Injury Benefits

In addition to welfare or insurance benefits, you may receive other payments for sickness and injury.

Workers' compensation received by you or your beneficiaries for your sickness or injury is fully exempt from tax. If you turn over your workers' compensation payments to your employer, and all or part of your regular salary continues to be paid, the part of your salary that is more than the amount of workers' compensation is taxable income as wages.

Example. You are hurt on the job, and are out of work for 6 weeks. Your employer continues to pay your salary of $200 a week, or $1,200, for the time you are absent. You receive $75 a week, or a total of $450, workers' compensation. Under your employment contract, you turn over all the compensation to your employer. The $75 a week is excluded from your income and the balance of $125 a week, or $750, is taxable.

Note: If part of your workers' compensation reduces your social security or equivalent railroad retirement benefits received, you may have to include part of the workers' compensation in income. For more information, see Chapter 12.

If you return to work after qualifying for workers' compensation, payments you continue to receive while assigned to light duties are taxable.

Federal Employees' Compensation Act payments for personal injuries or sickness, including payments to beneficiaries in case of death, are not taxable. However, amounts are taxable that are received under this act as "continuation of pay" for up to 45 days while a claim is being decided. Also, pay for sick leave while a claim is being processed is taxable and must be included in income as wages.

If you "buy back" sick leave so as to be eligible for nontaxable FECA benefits for the period you took the leave, the amount you spend to "buy back" leave you used in the same year reduces your taxable sick leave pay and is not separately deductible. The amount you spend to "buy back" sick leave you used in an earlier year is deductible only as a miscellaneous deduction, subject to the 2% limit, on Schedule A (Form 1040) in the year you pay it.

Other compensation. Most other amounts you receive as compensation for injury or illness are not taxable. These include:

Compensatory damages received for injury or illness (however, punitive damages are taxable),

Benefits received under an accident or health insurance policy attributable to premiums you paid,

Disability benefits received for loss of income or earning capacity as a result of injuries under a "no-fault" automobile policy, and

Compensation received for permanent loss, or loss of use of a part or function of your body, or for your permanent disfigurement.

This compensation must be figured only on the injury and not on the period of your absence from work. These benefits are exempt from tax even though your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care generally is not taxable. However, this reimbursement may reduce your medical expense deduction. For more information, see Chapter 23.

Scholarships and Fellowship Grants

If you receive a scholarship or fellowship grant, you may be able to exclude from income all or part of the amounts you receive. There are a number of restrictions on this exclusion, depending on the date of the grant and whether or not you were a candidate for a degree.

Qualified scholarships. Only a candidate for a degree may exclude amounts received as a qualified scholarship. This rule applies to scholarships or fellowships granted after August 16, 1986.

A qualified scholarship is any amount you receive that is used according to the conditions of the grant for:

- Tuition and fees to enroll or attend an educational organization or
- Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts that are used for room and board do not qualify.

All payments you receive for services must be included in income even if the services are a condition of receiving the grant and are required of all candidates for the degree. This includes amounts received for teaching and research.

See Publication 520, *Scholarships and Fellowship Grants,* for information on how to report the taxable portion of scholarships and fellowship grants.

Educational assistance allowances paid by the Veterans Administration are not included in gross income. These allowances are not considered scholarships or fellowship grants.

Scholarship prizes won in a contest are not scholarships or fellowships if you do not have to use the prizes for educational purposes. You must include these amounts in your gross income on line 22, Form 1040, whether or not you use the amounts for educational purposes.

Qualified tuition reductions. A qualified tuition reduction is excluded from your income. The term ***qualified tuition reduction*** means the amount of reduction in tuition for education furnished to an employee of an educational institution (or certain other persons), by any educational institution, if:

1) The tuition is for education below the graduate level,
2) The reduced tuition does not favor any highly compensated employee, and
3) The education is provided to a current employee, a former employee who retired or left on disability, a spouse, dependent child, widow, or widower of such an employee. If both parents have died, and if one of the parents qualified as an employee, the child may be a dependent of another person.

Graduate tuition reductions will remain eligible for exclusion as scholarships if they satisfy the requirements of a scholarship.

For more information on scholarships and fellowship grants, see Publication 520.

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14. Tax Shelters

Investments that yield tax benefits are sometimes called "tax shelters." In some cases, Congress has concluded that the loss of revenue is an acceptable side effect of special tax provisions designed to encourage taxpayers to make certain types of investments. In many cases, however, the loss produces little or no benefit to society or the tax benefits are exaggerated beyond those intended. Those cases are referred to as "abusive tax shelters." In recent years abusive tax shelters have been marketed in great numbers. As a result, an investment that is considered a tax shelter is subject to restrictions, including the requirement that it be registered, as discussed later, unless it is a projected income investment.

Passive activity losses and credits. Congress determined that extensive tax shelter activity contributed to public concerns about the fairness of the tax system. In response to these concerns, Congress enacted the passive activity loss and credit rules. These rules limit the amount of losses and credits that may be claimed from such activities and used to offset nonpassive income, such as certain portfolio income from investments. For more detailed information about determining and reporting income, losses, and credits from passive activities, see Publication 925, *Passive Activity and At-Risk Rules.*

Projected Income Investment

Special rules apply to a tax shelter that is not expected to reduce the tax liability of any investor. That tax shelter is considered to be a projected income investment. In order to qualify as a projected income investment, the tax shelter must not be expected to reduce the ***cumulative tax liability*** of any investor during any year of the first 5 years ending after the date the investment was offered for sale. The assets of a projected income investment must not include or relate to more than an incidental interest in:

1) Master sound recordings,
2) Motion picture or television films,
3) Videotapes,
4) Lithograph plates,
5) Copyrights,
6) Literary, musical, or artistic compositions, or
7) Collectibles (such as works of art, rugs, antiques, metals, gems, stamps, coins, or alcoholic beverages).

For more information about other specific requirements and exceptions that relate to a projected income investment, see the detailed discussion contained under *Tax Shelters* in Publication 550, *Investment Income and Expenses.*

Abusive Tax Shelters

Abusive tax shelters are marketing schemes that involve artificial transactions with little or no economic reality. They often make use of unrealistic allocations, inflated appraisals, losses in connection with nonrecourse loans, mismatching of income and deductions, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. Despite appearances to the contrary, the taxpayer generally risks little.

Abusive tax shelters commonly involve package deals that are designed from the start to generate losses, deductions, or credits far in excess of present or future investment, or that promise investors at the start future inflated appraisals to enable them, for example, to reap charitable contribution deductions based on those appraisals. (But, see the appraisal requirements discussed under *Curbing abusive tax shelters.*) They are commonly marketed in terms of the ratio of tax deductions allegedly available to each dollar invested. This ratio (or "write-off") is frequently said to be several times greater than one-to-one.

Since there are many abusive tax shelters and more are developed daily by promoters, it is not possible to list all the factors you should consider in determining whether an offering is an abusive tax shelter. However, you should ask the following questions, which might provide a clue to the abusive nature of the plan.

1) Do the tax benefits far outweigh the economic benefits?
2) Is this a transaction you would seriously consider, apart from the tax benefits, if you hoped to make a profit?
3) Do shelter assets really exist and, if so, are they insured for less than their purchase price?
4) Is there a nontax justification for the way profits and losses are allocated to partners?
5) Do the facts and supporting documents make economic sense? In that connection, are there sales and resales of the tax shelter property at ever increasing prices?
6) Does the investment plan involve a gimmick, device, or sham to hide the economic reality of the transaction?
7) Does the promoter offer to backdate documents after the close of the year and are you instructed to backdate checks covering your investment?
8) Is your debt a real debt or are you assured by the promoter that you will never have to pay it?
9) Does this transaction involve laundering United States source income through foreign corporations incorporated in a tax haven and owned by United States shareholders?

Curbing abusive tax shelters. Congress has enacted a series of income tax laws designed to halt the growth of abusive tax shelters. In addition to the new rules on passive activity losses and credits, some of the other provisions include the following:

1) ***Registration of tax shelters.*** Generally, the organizers of certain tax shelters must register the shelter with the Internal Revenue Service. The Service will then assign the tax shelter a registration number. If you are an investor in a tax shelter, the seller (or the transferor) must provide you with the tax shelter registration number at the time of the sale (or transfer) or within 20 days after the seller or transferor receives the number if that date is later. See *Investor Reporting,* later, for more information about reporting this number when filing your tax return.
2) ***List of investors.*** Organizers and sellers of any potentially abusive tax shelter must maintain a list identifying each investor. (This rule, however, does not apply to an investor who, as a seller, later transfers an interest in a tax shelter that is a projected income investment.) The list must be available for inspection by the Internal Revenue Service and the information required to be included on the list generally must be retained for 7 years. See *Transfer of interests in a tax shelter,* later, for additional information.
3) ***Appraisals of donated property.*** Generally, if the value of property you donate exceeds $5,000 ($10,000 in the case of privately traded stock), you must get a written "qualified" appraisal of the property's fair market value and attach an appraisal summary to your income tax return. See Publication 550 for information about who may be a "qualified" appraiser. For more information, see also Publication 561, *Determining the Value of Donated Property.*
4) ***Increased interest rate for tax motivated transactions.*** Any accrued interest that is related to the portion of a substantial underpayment of tax attributable to a tax motivated transaction will be imposed at a rate of 120% of the prescribed underpayment rate if such portion exceeds $1,000. Tax motivated transactions include any sham or fraudulent transaction, as well as any instance in which the value or adjusted basis of any property you claim on a return is 150% or more of the correct value or adjusted basis. Other tax motivated transactions are described under Internal Revenue Code section 6621(c)(3) and the related regulations.
5) ***Interest on penalties.*** If you are assessed a penalty for overvaluation of property or substantial understatement of tax, interest will be imposed on the amount of the penalty from the due date of the return (including any extensions) to the date of payment of the penalty.
6) ***Accounting methods and capitalization rules.*** Tax shelters generally may not use the cash method of accounting. Also, uniform capitalization rules generally apply to the production or purchase of inventory goods, to self-constructed business property, and to noninventory property produced or purchased for sale. Under the uniform capitalization rules, the direct cost and a portion of the indirect cost attributable to the property must be capitalized or included in inventory. For more information, see Publication 538, *Accounting Periods and Methods.*

Investor Reporting

If you include on your tax return any deduction, loss, credit or other tax benefit, or any income, from an interest in a tax shelter required to be registered, you must report the registration number the tax shelter provided to you. (See *Registration of tax shelters*, earlier.) Complete and attach Form 8271, *Investor Reporting of Tax Shelter Registration Number*, to your return to report the number and to provide other information about the tax shelter and its benefits. You must also attach Form 8271 to any application for tentative refund (Form 1045) and to any amended return (Form 1040X) on which such benefits are claimed or income is reported. If you do not include the registration number with your return, you will be subject to a penalty of $250 for each such failure unless the failure is due to reasonable cause.

Exception. Even if you have an interest in a registration-required tax shelter, you do not have to file Form 8271 if you did not claim any deduction, loss, credit or other tax benefit, or report any income from that tax shelter.

Transfer of interests in a tax shelter. If you hold an investment interest in a tax shelter and later transfer that interest to another person, you must either maintain a list identifying each person to whom you transferred your interest or require a designated person or seller to maintain the list. If you choose to delegate this requirement, you must submit to the designated person or seller all of the information that you would otherwise be required to maintain on the list.

If the tax shelter is not a projected income investment, described earlier, you must provide its registration number as well as a notification to each person to whom you transferred your interest in that tax shelter. See Publication 550 for more information about what this notification must include.

If you do not maintain the required list of investors, or do not delegate a designated person or seller to maintain the list, you will be subject to a penalty of $50 for each person required to be on the list, unless you can show that the failure to comply with this requirement was due to reasonable cause and not willful neglect. The maximum penalty under this provision is limited to $100,000 for each tax shelter in each calendar year.

Under certain circumstances, maintaining an identification list is not required for transfers of an interest in a projected income investment. See Publication 550 for more information.

Penalties. Investing in an abusive tax shelter may be an expensive proposition when you consider all of the consequences. First, the promoter generally charges a substantial fee. If your return is examined by the Internal Revenue Service and a tax deficiency is determined, you will be faced with payment of the tax, interest on the underpayment, possibly a 5% negligence penalty on the entire amount of any underpayment, or a 75% civil fraud penalty, and a penalty equal to 50% of the interest on the underpayment that is attributable to negligence or to fraud. Also, the penalty for failure to make the proper estimated tax payments may apply. Further, you may be subject to a penalty for substantial understatement of tax or the penalty for overvaluation of property, and the penalty for failure to pay tax. Most of these penalties are explained in Chapter 1. Other additional costs that an abusive tax shelter may generate are explained in the tax shelter discussion of Publication 550.

Caution: As this publication was being prepared for print, Congress was considering legislation that would repeal the penalty of 50% of the interest on the underpayment due to negligence or fraud. Instead, it would make interest on the negligence and fraud penalties payable beginning on the last day for filing the return, rather than on the last day for paying the underpayment.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Abusive tax shelter detection program. The Internal Revenue Service has implemented a program to detect and identify those returns, claims, or applications for refund, in which benefits from abusive tax shelter promotions are claimed. Under this program, the Service will detect and identify such returns, claims, and applications before processing and before refunds are paid. When appropriate, the Service will reduce refunds that are specifically attributable to the abusive tax shelter.

Returns subject to review under this program include those in which pre-filing notification letters, described later, have been sent to investors and those returns that are selected on the basis of certain criteria that identify particularly abusive tax shelter promotions.

Loss carryback adjustments. Under the detection program, the Service also may offset an assessed deficiency against a scheduled refund resulting from a decrease in tax based on the carryback of a net operating loss. (Form 1045, *Application for Tentative Refund*, is used to apply for a quick refund of taxes from such carrybacks.) See Publication 550 for more information about the Service's determination of such adjustments.

Pre-filing notification letter. If you are an investor in an abusive tax shelter promotion, the Internal Revenue Service may send you a "pre-filing notification letter," if it determines that it is highly likely that there is (1) a gross valuation overstatement, or (2) a false or fraudulent statement regarding the tax benefits to be derived from the tax shelter entity or arrangement. This letter will advise you that, based upon a review of the promotion, it is believed that the purported tax benefits are not allowable. The letter also will advise you of the possible tax consequences if you claim the benefits on your income tax return.

You also may receive a notification letter after you file your tax return. If you have already claimed the benefits on your tax return, you will be advised that you may file an amended return. However, any applicable penalties still may be asserted.

If you claim the benefits after receiving the pre-filing notification or if you fail to amend your return, you will be notified that your tax return is being examined. Normal audit and appeal procedures will be followed during the examination, and negligence, civil or criminal fraud, overvaluation, substantial understatement, and other penalties will be considered and, when appropriate, asserted. For information on the examination of returns, see *The Examination and Appeals Process* at the end of this publication.

Revenue rulings. The Internal Revenue Service has published numerous revenue rulings concluding that the claimed tax benefits of various abusive tax shelters should be disallowed. A revenue ruling is the conclusion of the Internal Revenue Service on how the law is applied to a particular set of facts. Revenue rulings are published in the Internal Revenue Bulletin for taxpayers' guidance and information and also for use by Internal Revenue Service officials. So, if your return is examined and an abusive tax shelter is identified and challenged, a published revenue ruling dealing with that type of shelter, which disallows certain claimed tax shelter benefits, would serve as the basis for the examining official's challenge of the tax benefits that you claimed. In such a case the examiner will not compromise even if you or your representative believe that you have authority for the positions taken on your tax return.

The courts have generally been unsympathetic to taxpayers involved in abusive tax shelter schemes and have ruled in favor of the Internal Revenue Service in the majority of the cases in which these shelters have been challenged.

New financial products. The Internal Revenue Service's Office of Chief Counsel has an organization devoted to identifying and analyzing new financial products that are being created and sold to investors in public offerings. This organization provides guidance about the tax consequences of transactions through the issuance of revenue rulings and regulations.

The Internal Revenue Service encourages taxpayers and tax practitioners to submit prospectuses and/or other written descriptions of current investment transactions to the Office of Chief Counsel at the following address:

Assistant Chief Counsel
(Financial Institutions and Products)
Room 4300
Internal Revenue Service
1111 Constitution Ave., N.W.
Washington, D.C. 20224

Whether to invest. In light of the adverse tax consequences and the substantial amount of penalties and interest that may result if the Internal Revenue Service disallows the claimed tax benefits, you should consider tax shelter investments carefully, and seek competent legal and financial advice.

Part III
Gains and Losses

A gain from selling stocks, bonds, or other investment property may be taxed or it may be tax free, at least in part. A loss may or may not be deductible. The chapters in this part discuss these investment gains and losses. They also discuss gains from selling property you personally use — including the special rules for selling your home. Nonbusiness casualty and theft losses are discussed in Chapter 27 of Part V.

15. Basis of Property

Basis is a way of measuring your investment in property for tax purposes. The basis of property is used to figure the deductions for depreciation, amortization, depletion, and casualty losses. Basis is also used to figure gain or loss on the sale or other disposition of property. You must keep accurate records of all items that affect the basis of property so that you can make these computations.

This chapter is divided into three sections: Cost Basis, Adjusted Basis, and Other Basis.

The basis of property you buy is usually its cost to you. This cost may include items, such as, sales tax, certain real estate taxes, settlement fees, and various other costs if you construct an asset.

Your original basis in property (whether cost or other) must be increased or decreased (adjusted) for certain events. If you make improvements to the property, this will increase your basis. If you take deductions for depreciation or casualty losses, this will reduce your basis.

Your basis in some assets cannot be determined by cost. This includes property you receive as a gift or inheritance. It also applies to property received in an involuntary exchange, and certain other circumstances.

This chapter does not reflect the provisions of the Bankruptcy Act of 1980. If any of your debts were cancelled by a creditor, or were discharged because you became bankrupt, the basis of your assets might be affected. For information about the effect these provisions may have on basis, see Publication 908, *Bankruptcy and Other Debt Cancellation.*

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount of cash you pay for it, and the fair market value of other property or services you provide in the transaction. Your cost also includes amounts you pay for:

1) The sales tax charged on the purchase,
2) Freight charges to obtain the property, and
3) Installation and testing charges.

In addition, the cost basis of real estate and business assets will include other items.

Unstated interest. If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price, less the amount considered to be unstated interest. For more information, see Publication 537, *Installment Sales.*

Real Property

If you buy real property, certain fees and other expenses you pay are part of your basis in the property.

Assumption of a mortgage. If you buy property and become liable for an existing mortgage on the property, your basis is the amount you pay for the property in cash plus the unpaid mortgage you assume.

Settlement fees and other costs. Legal and recording fees are some of the settlement fees or closing costs that are included in the basis of property. Some others are:

1) Abstract fees,
2) Charges for installing utility services,
3) Surveys,
4) Transfer taxes,
5) Title insurance, and
6) Any amounts owed by the seller that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

You must reasonably allocate these fees or costs between land and improvements to figure the basis for depreciation of the improvements. Settlement fees do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

Real estate taxes. If you buy real property and agree to pay taxes that were owed by the seller, the taxes you pay are treated as part of the cost of the property. You may not deduct them as taxes paid. If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount. Do not include that amount in the cost of the property.

Adjusted Basis

Before you can figure any gain or loss on a sale, exchange, or other disposition of property, or figure allowable depreciation, depletion, or amortization, you usually must make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to Basis

The basis of any property is increased by all items that are properly added to a capital account. This includes the cost of any improvements having a useful life of more than one year and amounts spent after a casualty to restore the damaged property. Other items added to the basis of property include the cost of extending utility service lines to the property, and legal fees, such as the cost of defending and perfecting title.

Improvements. The cost of improvements that add to the value of property, lengthen its life, or adapt it to a different use is added to your basis in the property. For example, putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway are improvements and their costs are added to your basis in your home.

Assessments for local improvements, such as streets and sidewalks, which tend to increase the value of the property assessed must be added to the basis of the property and not deducted as taxes. For example, if your city puts in a paved sidewalk along the street running in front of your home, and assesses you and the other affected landowners for the cost of the sidewalk, you must add the assessment to the basis of your property. However, assessments for maintenance or repair or meeting interest charges on the improvements are deductible as taxes.

Decreases to Basis

You must decrease the basis of your property by any items that represent a return of capital, such as the receipt of nontaxable dividends.

Casualties and thefts. If you have a casualty or theft loss, you must decrease the basis of your property by the amount of any insurance or other reimbursement that you receive and by any deductible loss that is not covered by insurance. However, you increase your basis for amounts you spend after a casualty to restore the damaged property. For more information, see Chapter 27.

Easements. The amount you receive for granting an easement usually is considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, your basis is reduced to zero and the excess is a recognized gain.

Residential energy credit. The residential energy credit is no longer available. However, if you were allowed this credit, you must decrease the basis of your home by the amount of the credit allowed, if you added the cost of the energy items to the basis of your home.

Section 179 deduction. If you elect to take the section 179 deduction for any part of the cost of property, you must decrease the basis of the property by the amount of the section 179 deduction.

Depreciation. You must decrease the basis of your property by the amount of depreciation that you could have deducted on your tax returns under the method of depreciation you selected. If you deducted more depreciation than you should have, you must decrease your basis by the amount you should have deducted, plus the part of the excess deducted that resulted in a decrease in your tax liability for any year. However, if you deducted less depreciation than you could have, you must decrease your basis by the amount that you could have deducted. Usually, you figure the amount of depreciation you could have deducted by using the accelerated cost recovery system (ACRS) or the modified accelerated cost recovery system (MACRS) for recovery property and the straight line method for other property.

Adjusted Basis Example

You owned a duplex used as rental property that cost you $40,000. The $40,000 cost was allocated $35,000 for the building and $5,000 for the land. You added an improvement to the duplex that cost $10,000. On February 1, 1987, the duplex was damaged by fire. Up to that time you had been allowed depreciation of $23,000. You sold the salvage for $1,300 and collected $19,700 from your insurance company. You deducted a casualty loss of $1,000 on your 1987 income tax return. You spent $19,000 of the insurance proceeds for restoration of the duplex, which was completed in 1988. The adjusted basis of the duplex, after the restoration, is figured as follows:

Original cost of duplex		$35,000
Addition to duplex		10,000
Total cost of duplex		$45,000
Minus: Depreciation		23,000
Adjusted basis before casualty		$22,000
Minus: Casualty loss	$ 1,000	
Insurance proceeds	19,700	
Salvage proceeds	1,300	22,000
Adjusted basis after casualty		$ -0-
Add: Cost of restoring duplex		19,000
Adjusted basis after restoration		$19,000

Your basis in the land is its original cost of $5,000.

Other Basis

There are many times when you cannot use cost as a basis. In these cases the fair market value or the adjusted basis of certain property may be important.

Fair market value is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts. Sales of similar property, on or about the same date, may be helpful in figuring the fair market value of the property.

Property received for services. If you receive property for your services, you must include the property's fair market value in income. The amount that you include in income becomes your basis.

Restricted property. If you receive property for your services and the property is subject to certain restrictions, your basis in the property is its fair market value when you can transfer it or when it is not subject to a substantial risk of forfeiture. For more information, see the discussion on *Restricted Property Received for Services*, in Publication 525, *Taxable and Nontaxable Income*.

Bargain purchases. If your employer lets you purchase goods or other property at less than fair market value, you have to include the difference between the purchase price and the fair market value of the property in your income. However, if this difference represents a qualified employee discount, you do not include the difference in income. (See Chapter 6 for information about qualified employee discounts.) Your basis in the property is its fair market value, that is, your purchase price plus the amount (if any) you include in your income.

Taxable exchanges. A taxable exchange is one in which the gain is taxable or the loss is deductible. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its fair market value at the time of the exchange.

Involuntary Exchanges

If you acquire property as a result of an involuntary exchange, such as a casualty, theft, or condemnation, the basis of the replacement property you acquire may be figured using the basis of the property exchanged.

Similar or related property. If you receive property that is similar or related in service or use to the property exchanged, the basis of the new property is the same as the basis of the old property, decreased by any loss recognized on the exchange and money received that was not spent on similar property and increased by any gain recognized on the exchange and any added cost of getting the new property.

Not similar or related property. If you receive money or other property that is not similar or related in service or use to the old property, and you buy new property that is similar or related in service or use to the old property, the basis of the new property is the cost of the new property, decreased by the amount of gain that is not recognized on the exchange.

Example. Your property was condemned by the state. The property had an adjusted basis of $26,000, and the state paid you $31,000 for it. You realized a gain of $5,000 ($31,000 − $26,000). You bought new property that is similar in use to the old property for $29,000, and you chose to recognize a gain of $2,000 ($31,000 − $29,000), the unspent part of the payment from the state. The basis of the new property is figured as follows:

Cost of new property	$29,000
Minus: Gain not recognized	3,000
Basis of the new property	$26,000

Allocating the basis. You must allocate the basis among the parts of the new property you acquire as a result of an involuntary exchange. This allocation usually is based on the ratios of the fair market value of each part of the new property to the total fair market value of the whole new property.

If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs. If, in the previous example, the state had condemned unimproved real property, and the new property you bought was improved real property with both land and buildings, you would allocate the basis of the new property, $26,000, between land and buildings based on their fair market values.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which any gain from the exchange is not taxed and any loss cannot be deducted. In a nontaxable exchange, business or investment property is exchanged solely for like property, stock is exchanged solely for stock of the same corporation, or property is exchanged for securities of a controlled corporation.

A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property.

The basis of property you receive in a nontaxable or partially nontaxable exchange is usually the same as the basis of the property exchanged ***decreased*** by any money you received and any loss recognized on the exchange; and then ***increased*** by any additional costs incurred, and any gain recognized on the exchange. See Chapter 16 for a discussion of nontaxable exchanges.

The basis, as figured under this method, must be allocated among the properties, other than money, that you received in the exchange. In making this allocation, the basis of the unlike property is its fair market value on the date of exchange. The remainder is the basis of the like property.

Example. You trade in an old truck, that has an adjusted basis of $1,700, for a new one costing $6,800. The dealer allows you $2,000 on the old truck and you pay $4,800 in cash. This is a nontaxable exchange and the basis of the new truck is $6,500, that is, the adjusted basis of the old one, $1,700, increased by the additional cost, $4,800. If you sell your old truck to a third party for $2,000 and then buy the new one from the dealer, you have a taxable gain on the sale, and the basis of the new truck is the price you pay the dealer for it.

Trade-in or sale and purchase. You may not increase the basis of property for depreciation by selling your old property outright to a dealer and then buying the new property from the same dealer if the sale and purchase are actually a single transaction. If the sale to the dealer of your old property and your purchase from that dealer of the new property are dependent on each other, you are considered to have traded in your old property. The transaction is treated as an exchange no matter how it is carried out.

Example. You are a salesperson and use one of your cars 100% for business. You have used this car in your sales activities for 2 years and have depreciated it. Your adjusted basis in the car is $2,600 and its market value is $3,100.

You are interested in a new car with a listed retail price of $8,695, which usually sells for $8,000. If you trade your old car for the new one and pay the dealer $4,900, your basis for depreciation for the new car would be $7,500 ($4,900 cash plus $2,600 basis of your old car). However, you want a higher basis for depreciating the new car, so you agree to pay the dealer $8,000 cash for the new car if he will pay you $3,100 for your old car.

Since the sale and purchase are dependent on each other, you are treated as if you had exchanged your old car for the new one. Your basis for depreciating the new car is $7,500, which is the same as it would be if you had traded the old car.

For information about the trade of a car used partly for business, see Publication 917, *Business Use of a Car*.

Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its fair market value (FMV) at the time it was given to you and the amount of gift tax paid on it.

FMV less than donor's adjusted basis. If the FMV of the property was less than the donor's adjusted basis, your basis for depreciation, depletion, and amortization, and for gain on its sale or other disposition is the same as the donor's adjusted basis. Your basis for loss on its sale or other disposition is its FMV at the time you received the gift.

FMV more than donor's adjusted basis. If the FMV of the property was equal to or greater than the donor's adjusted basis, your basis is the same as the donor's adjusted basis at the time you received the gift. Your basis is increased by all or part of the gift tax paid, depending on the date of the gift.

Gift received before 1977. If you received a gift before 1977, your basis in the gift (the donor's adjusted basis) is increased by the total gift tax paid on it, but not above the FMV of the gift when it was given to you.

Example 1. You were given a house in 1976. At that time it had a FMV of $21,000, and the donor's adjusted basis was $20,000. The donor paid a gift tax of $500. Your basis for gain or loss and for depreciation is $20,500, the donor's adjusted basis plus the gift tax paid.

Example 2. If, in Example 1, the gift tax paid had been $1,500, your basis would be $21,000. This is the donor's adjusted basis plus the gift tax paid, but it is limited to the FMV of the house at the time you received the gift.

Gift received after 1976. If you received a gift after 1976, your basis in the gift (the donor's adjusted basis) is increased by the part of the gift tax paid that is due to the net increase in value of the gift. This part is figured by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) of the fraction is the net increase in value of the gift and the denominator (bottom part) is the amount of the gift. The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis.

Example. In 1988 you received a gift of property from your mother. At that time the property had a FMV of $50,000 and her adjusted basis was $20,000. She paid a gift tax of $9,000 on the property. For figuring depreciation, depletion, amortization, and gain or loss, your basis is $25,400, figured as follows:

Fair market value	$50,000
Minus: Adjusted basis	20,000
Net increase in value	$30,000
Gift tax paid	$ 9,000
Multiplied by ($30,000 ÷ $50,000)	.60
Gift tax due to net increase in value	$ 5,400
Adjusted basis of property to your mother	20,000
Your basis in the property	$25,400

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse, or by your former spouse if the transfer is incident to divorce, is the same as the transferor's adjusted basis of the property. However, your basis is adjusted for any gain recognized by the transferor on a transfer of property in trust in which the sum of the liabilities assumed, plus the liabilities to which the property is subject, is more than the adjusted basis of the property transferred.

If the property transferred is a Series E or EE United States savings bond, the transferor must include in income the interest accrued to the date of transfer. The transferee's basis in the bond immediately after the transfer is equal to the transferor's adjusted basis in the bond increased by the interest income includible in the transferor's income.

The transferor must supply you with records necessary to determine the adjusted basis of the property as of the date of the transfer. For more information regarding the transfer of property between spouses, see Chapter 16.

Inherited Property

Your basis in property you inherit is usually its fair market value (FMV) at the date of the decedent's death. If a federal estate tax return has to be filed, and if the property must be included in the decedent's gross estate, your basis in property you inherit is its FMV at the alternate valuation date if the estate qualifies and elects to use alternate valuation. If a federal estate tax return does not have to be filed, your basis in the property is its appraised value at the date of death for state inheritance or transmission taxes.

Your basis in inherited property may also be figured under the special farm or closely held business real property valuation method, if chosen for estate tax purposes. See Publication 448, *Federal Estate and Gift Taxes*, for information on valuation methods for estate tax purposes.

For more information about the basis of inherited property, see Publication 551, *Basis of Assets*.

Property Changed to Business or Rental Use

When you hold property for personal use and change it to business use or use it to produce rent, such as renting out your former home, you must figure the basis for depreciation.

The basis for depreciation equals the lesser of:

1) The FMV of the property on the date of the change, or

2) Your adjusted basis on the date of the change—that is, your original cost or other basis of the property, plus the cost of permanent improvements or additions since you acquired it, minus deductions for any casualty losses claimed on earlier years' income tax returns and other decreases to basis.

Example. Several years ago you built your home for $40,000 on a lot that cost you $4,000. Before changing the property to rental use last year, you added $8,000 of permanent improvements to the house and claimed a $1,000 deduction for a casualty loss to the house. Because land is not depreciable, you can only include the cost of the house when figuring the basis for depreciation.

Your adjusted basis at the time of the change in use is $47,000 ($40,000 + $8,000 − $1,000). On the date of the change in use, your property has a FMV of $48,000, of which $6,000 is for the land and $42,000 is for the house. The basis for depreciation on the house is the FMV at the date of the change ($42,000) because it is less than your adjusted basis ($47,000).

If you later sell or dispose of the property, the basis of the property to be used will depend on whether you are figuring gain or loss.

The basis for gain is your adjusted basis when you sell the property—that is, your original cost or other basis, plus the cost of any permanent improvements or additions, less depreciation allowed or allowable, deductions for casualty losses claimed on prior years' returns, and other decreases to basis, such as amounts received for easements or rights-of-way.

The basis for loss is figured using the smaller of your adjusted basis or the FMV of the property at the time of the change to business or rental use. Increase this amount by the cost of improvements and additions you made after the change, and reduce it by your depreciation and casualty loss deductions you claimed after the change.

Example. You sell your house, which you had changed to rental property after using it as your home. You originally bought the house for $35,000. When you changed it to rental use, it had a FMV of $33,000. You claimed $3,000 depreciation, figured under the straight line method, while renting it, so your adjusted basis at the time of the sale, for figuring gain, is $32,000, and for figuring loss is $30,000. If the sales price is between $30,000 and $32,000, you have neither a gain nor a loss on the sale.

Stocks and Bonds

The cost basis of stocks or bonds is the purchase price plus the costs of purchase such as commissions and recording or transfer fees. If you acquired stocks or bonds other than by purchase, your basis is usually determined by fair market value or the donor's adjusted basis, as previously discussed.

The basis must be adjusted for certain events that occur after purchase. For example, if you receive additional stock from nontaxable stock dividends or stock splits, you must reduce the basis of your original stock. You must also reduce your basis when you receive nontaxable distributions because these are a return of capital.

Example. In 1986, you bought 100 shares of XYZ stock for $1,000 or $10 a share. In 1987, you bought 100 shares of XYZ stock for $1,600 or $16 a share. In 1988, XYZ declared a 2-for-1 stock split. You now have 200 shares of stock with a basis of $5 a share and 200 shares with a basis of $8 a share.

Other basis. There are other ways to determine the basis of stocks or bonds depending on how you acquired them. Some ways in which you can acquire stock are by automatic investment programs, dividend reinvestment plans, and stock rights. For detailed information, see Publication 550, *Investment Income and Expenses*.

Identifying shares. If you buy and sell securities at different times in varying quantities and you cannot definitely identify the securities you sell, the basis of those sold is figured under the first-in first-out method—that is, the first securities you acquired are the first sold.

Identification. You make an adequate identification if you deliver to your broker or agent certificates for securities that you purchased on a certain date or for a specific price.

If you left the security certificates with your broker or other agent, an adequate identification is made if you:

1) Tell your broker the particular security to be sold or transferred at the time of the sale or transfer, and
2) Receive a written confirmation of this from your broker or other agent within a reasonable time.

If you bought securities in different lots at different times and you hold a single certificate for these securities, you make an adequate identification if you:

1) Tell your broker the particular security to be sold or transferred when you deliver the certificate to your broker, and
2) Receive a written confirmation of this from your broker or other agent within a reasonable time.

Mutual fund shares. You may choose to use the average basis of shares you own in a regulated investment company if you acquired the shares at different times and prices, and if you left the shares on deposit in an account kept by a custodian or agent. For more information, see Publication 564, *Mutual Fund Distributions.*

Premiums on bonds. If you buy a taxable bond at a premium, and choose to amortize the premium paid, you must reduce the basis of the bond by the amount of the amortized premium. See Chapter 25 for information about the deductibility of the amount amortized. Although you may not take a deduction for the premium on tax-exempt bonds, you must amortize the premium and decrease your basis in the bonds by the amount of the amortizable bond premium.

Original issue discount (OID) on debt instruments. You must increase your basis in an OID debt instrument (see Chapter 8) by the amount of OID that you included in income for that instrument.

Tax-exempt bonds. OID on tax-exempt bonds is not taxable. However, there are special rules for determining basis on tax-exempt original issue discount bonds issued after September 3, 1982, and acquired after March 1, 1984. See Publication 550.

16. Sale of Property

Important Changes for 1988

Capital gain. If you have a capital gain, it is taxable at the same rate as your ordinary income.

Holding period. For most capital assets acquired after December 31, 1987, the holding period for a long-term gain or loss is more than one year, and the holding period for a short-term gain or loss is one year or less.

This chapter explains how you figure your gain or loss when you sell or trade investment property. To determine whether you had a gain or loss on a sale of property, you generally subtract your adjusted basis from the amount you realize. This chapter includes information about the difference between a sale and a trade, nontaxable trades, and capital and noncapital assets.

Certain sales or trades of property are discussed in other IRS publications. They include, for example, installment sales, covered in Publication 537, *Installment Sales,* and transfers of property at death, covered in Publication 559, *Tax Information for Survivors, Executors, and Administrators.*

Publication 544, *Sales and Other Dispositions of Assets,* provides information about various types of transactions involving business property and the tax results of different types of gains and losses. The property transactions described in Publication 544 include dispositions of assets used in a trade or business or for the production of income, and transactions involving real and personal property, leases, easements, life estates, inventions, copyrights, timber, and coal.

Publication 550, *Investment Income and Expenses,* provides more detailed discussion about sales and trades of investment property. Publication 550 includes information about the rules covering straddles, section 1256 contracts, puts and calls, commodity futures, short sales and wash sales. It also discusses investment-related expenses.

Publication 925, *Passive Activity and At-Risk Rules,* discusses the rules that limit losses and credits from ***passive activities*** as well as the rules that apply on the disposition of an interest in a passive activity.

For information about the tax treatment of selling your home, see Chapter 17.

Form 1099–B. If you sold property such as securities, commodities, bonds, etc., through a broker, you should receive Form 1099–B, *Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions,* or an equivalent statement from the broker. You should receive the statement by January 31, 1989, showing the gross proceeds from sales during 1988. The Internal Revenue Service will also get a copy of Form 1099–B from the broker.

If you receive a Form 1099–B or equivalent statement, you will have to complete Schedule D (Form 1040). If you are required to file a return, a negligence penalty (described in Chapter 1) will be imposed on you if this income is taxable and it has not been reported.

Unstated interest and imputed principal rules for sales or exchanges. For information about the unstated interest rules applicable to certain payments received on account of a ***seller-financed*** sale or exchange of property, and about the imputed principal rules applicable to any debt instrument issued on account of such transactions, see Publication 537, *Installment Sales.*

Sales and Trades

Sales and trades (or exchanges) of assets generally result in taxable gains or deductible losses, although some trades of property are nontaxable.

What is a Sale or Trade?

A sale is generally a transfer of property for money only or for a mortgage, note, or some other promise to pay money. A trade is a transfer of property for other property or services, and may be taxed in the same way as a sale.

Sale and purchase. Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. Such a sale and purchase are two separate transactions.

A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Dividend vs. sale or trade. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

1) The redemption is not essentially equivalent to a dividend (see Chapter 9),
2) There is a substantially disproportionate redemption of stock,
3) There is a complete redemption of all the stock of the corporation owned by the shareholder, or
4) The redemption is a distribution in partial liquidation of a corporation.

A redemption of bonds or notes at their maturity is a sale or trade that you must report on Schedule D (Form 1040) whether or not you realize gain or loss on the transaction.

However, if the issuer has merely extended the maturity date of its notes, during which period some of the noteholders have agreed not to redeem their notes until all the other notes are retired or their retirement is provided for, neither a trade nor a closed or completed transaction has occurred. Under these circumstances, you do not figure gain or loss.

A surrender of stock by a dominant shareholder, who retains control of the corporation, does not result in an immediate loss deductible from taxable income. Rather, the surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

Figuring a Gain or Loss

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property.

Gain is the amount you realize from a sale or trade minus the adjusted basis of the property you transfer.

Loss is the adjusted basis of the property minus the amount you realize.

The adjusted basis of property is your original cost or other original basis properly adjusted (increased or decreased) for items such as purchase commissions and legal fees. In determining gain or loss, the cost of transferring property to the new owner, such as selling expenses, is added to the adjusted basis of the property. See Chapter 15 for more information about determining the adjusted basis of property.

Amount realized. The amount you realize from a sale or trade is the total of all money you receive plus the fair market value of all property or services you receive.

Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the necessary facts.

The fair market value of notes or other evidence of indebtedness you receive as a part of the sale price is usually the best amount you can get from selling them to, or discounting them with, a bank or other buyer of such debt instruments.

An indebtedness against the property, or against you, that is paid off as a part of the transaction or that is assumed by the buyer must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize includes the full amount of the note assumed by the buyer even though the amount of the note exceeds the fair market value of the property.

Payment of cash. If you trade property for other property and in addition pay cash, the amount you realize is the fair market value of the property you receive. You determine your gain or loss by subtracting your adjusted basis (the cash you pay plus the adjusted basis of the property you traded in) from the amount you realize.

Example 1. You sell stock which you had pledged as security for a bank loan of $8,000. Your basis in the stock is $6,000. The buyer pays off your bank loan and pays you $20,000 in cash. The amount realized is $28,000 ($20,000 plus $8,000). Your gain is $22,000 ($28,000 minus $6,000).

Example 2. You trade A Company stock with an adjusted basis of $7,000 for B Company stock with a fair market value of $10,000, which is your amount realized. Your gain is $3,000 ($10,000 minus $7,000). If you also receive a note for $6,000 that has a discount value of $4,000, your gain is $7,000 ($10,000 plus $4,000 minus $7,000).

No gain or loss. In some cases you may be required to use a basis for figuring gain different from that used for figuring loss. See Chapter 15. In these situations, if you use the basis for determining a gain and figure a loss, and then use the basis for determining a loss and figure a gain, you will have neither a gain nor a loss.

Example. You receive a gift of investment property having an adjusted basis of $10,000 at the time of the gift. The fair market value at the time of the gift is $9,000. You later sell the property for $9,500. You have neither gain nor loss. Your basis for figuring gain is $10,000 and $10,000 minus $9,500 results in a $500 loss. Your basis for figuring loss is $9,000 and $9,500 minus $9,000 results in a $500 gain.

Nontaxable Trades

Certain trades or exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even though you may realize a gain or loss on the exchange, it will not be recognized for tax purposes. The property you get carries over the basis of the property you had before the exchange.

Like-kind exchanges. The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be nontaxable, a like-kind exchange must meet all six of the following conditions—

1) The property must be business or investment property. You must hold both the property you trade and the property you receive for business or investment purposes. Neither property may be used for personal purposes, such as your home or family car.

2) The property must not be property held for sale. Neither the property you trade nor the property you receive may be property you sell to customers, such as merchandise. It must be property held for investment, or property held for productive use in your trade or business.

3) There must be an exchange of like property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like property. The trade of an apartment house for a store building or a panel truck for a pickup truck are like-kind exchanges. The exchange of a piece of machinery for a store building is not a like-kind exchange.

4) The property must be tangible property. These rules and benefits do not apply to exchanges of stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidence of indebtedness or interest, including the exchange of partnership interests. However, you may have a nontaxable exchange of corporate stocks, as discussed later.

5) The property must meet the identification requirement. The property to be received must be identified on or before the day that is 45 days after the date of transfer of the property given up in the exchange.

6) The exchange must meet the completed transaction requirement. The property must be received on or before the earlier of:

    a) The 180th day after the date on which you transfer the property given up in the transfer, or

    b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

Partially nontaxable exchange. If, in addition to like property, you receive money or unlike property, and the above conditions are met, you have a partially nontaxable trade. You are taxed on the gain you realize, but only to the extent of the cash and the fair market value of the unlike property you receive. You may not deduct a loss.

If you pay money in addition to giving up like property in a like-kind exchange, you have no taxable gain or deductible loss.

If you give up unlike property in addition to the like property, you must recognize gain or loss only on the unlike property you give up. The gain or loss is the difference between the fair market value of the unlike property and the property's adjusted basis. See Publication 544 for more information about partially nontaxable exchanges.

To figure the basis of the property received, see *Nontaxable exchanges* in Chapter 15.

Transfers of property between spouses or incident to divorce. Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or to a former spouse if incident to a divorce. This rule does not apply if the recipient-spouse is a nonresident alien. The rule also does not apply to a transfer in trust if the adjusted basis of the property is less than the amount of the liabilities assumed and liabilities on the property.

Caution: As this publication was being prepared for print, Congress was considering legislation that would extend gain or loss treatment, on transfers of property to nonresident alien recipient-spouses, to transfers after June 21, 1988, to nonresident alien recipient-former spouses.

It would also clarify that a transfer of stock, acquired upon exercise of an incentive stock option, between spouses or incident to divorce is tax free.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the transferee as acquired by gift and is not considered as a sale or exchange. The transferee's basis in the property will be the same as the adjusted basis of the transferor immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the property transferred is less than, equal to, or greater than its fair market value at the time of transfer, and applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis. For more information, see Publication 504, *Tax Information for Divorced or Separated Individuals.*

A transfer of property is incident to a divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage. For transfers that do not come under these rules, see *Related Party Transactions,* later.

Corporate stocks. The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

Stock for stock of the same corporation. You may exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two persons as well as a trade between a stockholder and a corporation. See Publication 550 for more information.

Convertible stocks and bonds. You will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate. See Publication 550 for more information.

Property for stock. If you transfer property to a corporation in exchange for stock or securities in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

However, if you had a gain from the disposition of depreciable property from this transaction, you may be taxed on part of the gain. See Publication 544 for information on the disposition of depreciable property.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation. See Publication 544 for information about other exchanges for corporate stocks.

Insurance policies and annuities. You will not have a recognized gain or loss if you trade:

1) A life insurance contract for another life insurance contract or for an endowment or an annuity contract,
2) An endowment contract for an annuity contract or for another endowment contract providing for regular payments beginning at a date not later than the beginning date under the old contract, or
3) An annuity contract for another annuity contract.

The insured or annuitant must stay the same as under the original contract. Exchanges of these contracts that are not included in this list, such as an annuity contract for an endowment contract, are taxable.

U.S. Treasury notes or bonds. You may trade certain issues of U.S. Treasury obligations for certain other issues, designated by the Secretary of the Treasury, with no gain or loss recognized on the trade. See Publication 550 for information about the tax treatment of income from these investments. For other information on Treasury notes or bonds, write to the

Bureau of the Public Debt
U.S. Treasury Department
Washington, DC 20239-1000

Related Party Transactions

Special rules apply to the sale or trade of property between related parties.

A loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between you and the following related parties:

1) Members of your family—your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
2) A corporation in which you own directly or indirectly more than 50% in value of the outstanding stock (see *Ownership of stock*, following).
3) An exempt charitable or educational organization that is controlled in any manner or by any method, directly or indirectly, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties:

1) A grantor and fiduciary, and the fiduciary and beneficiary, of any trust,
2) Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts,
3) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for the trust, or by or for the grantor of the trust,
4) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership,
5) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation,
6) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation, or
7) Two corporations that are members of the same controlled group (under certain conditions, however, such losses are not disallowed but must be deferred).

If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you may not deduct the loss on any item. Also, you may not reduce gains from the sales of any of these items by losses on the sales of any of the other items.

Indirect transactions include sales through a stock exchange. You may not deduct your loss on the sale of stock through your broker if, for example, under a prearranged plan a related person or entity buys the same stock that you had owned.

Ownership of stock. In determining whether a person ***directly or indirectly*** owns any of the outstanding stock of a corporation, the following rules apply.

Rule 1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered to own the stock owned, directly or indirectly, by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning (other than by applying rule 2) any stock in a corporation is considered to own the stock owned directly or indirectly by or for his or her partner.

Rule 4. Stock constructively owned by a person under rule 1 is treated as actually owned by that person, for applying rules 1, 2, or 3. But stock constructively owned by an individual under rule 2 or 3 is not treated as owned by that individual for again applying either rule 2 or 3 to make another person the constructive owner of the stock.

Property received from a related party. If you sell or trade property that you got from a related party, you recognize the gain only to the extent it is more than the loss previously disallowed to the transferor. This rule applies only if you are the original transferee.

Example 1. Your brother sells you stock with a cost basis of $10,000 for $7,600. Your brother cannot deduct the loss of $2,400. Later, you sell the same stock to an unrelated party for $10,500, thus realizing a gain of $2,900. Your reportable gain is $500, the $2,900 gain minus the $2,400 loss not allowed to your brother.

Example 2. Assume the same facts as before, except that you sold the stock for $6,900 instead of $10,500. Your recognized loss is only $700 ($7,600 basis minus $6,900). You cannot deduct the loss that was not allowed to your brother.

Gain on sale or trade of depreciable property. If you have a recognized gain on the sale or trade of property, including a leasehold or a patent application, that is depreciable property in the hands of the party who receives it, the capital gain provisions do not apply and the gain is ordinary income if the transaction is between certain related parties (including controlled entities). See Publication 544 for more information.

Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a capital asset. Some examples are: stocks or bonds held in your personal account; a house owned and used by you and your family; household furnishings; a car used for pleasure or commuting; coin or stamp collections; gems and jewelry; gold, silver, or any other metal.

Capital assets do not include:

1) ***Property held mainly for sale to customers*** or property that will physically become a part of the merchandise that is for sale to customers;
2) ***Accounts or notes receivable*** acquired in the ordinary course of a trade or business, or for services rendered as an employee, or from the sale of any of the properties described in (1);
3) ***Depreciable property*** used in your trade or business, even though fully depreciated;
4) ***Real property*** used in your trade or business;
5) ***A copyright, a literary, musical, or artistic composition, a letter or memorandum,*** or similar property that you created by your personal efforts; that was prepared or produced for you as a letter, memorandum, or similar property; or that you acquired under circumstances (for example, by gift) entitling you to the basis of a person who created the property or for whom it was prepared or produced; and
6) ***U.S. Government publications*** that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.

Noncapital assets. Noncapital assets include the six items listed above as exceptions to capital assets.

Capital or Ordinary Gain or Loss

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. In some situations, part of your gain or loss may be a capital gain or loss and part may be an ordinary gain or loss. For information about transactions that are not discussed here, refer to those IRS publications described at the beginning of this chapter.

This part discusses the tax treatment of gains and losses from several types of transactions.

Character of gain or loss. It is important for you to properly distinguish or classify your gains and losses as either ordinary or capital gains or losses and as either short-term or long-term gains or losses. These distinctions are essential to correctly arrive at your net capital gain or loss. The correct classification of your gains and losses is important for determining the limit on capital losses.

For information about determining whether your gain or loss was a short-term or long-term capital gain or loss, see the discussion under *Holding Period,* later in this chapter. For more information about figuring your capital gain income and determining your allowable capital losses, see Chapter 18.

Property Held for Personal Use

Property held for personal use is a capital asset. Gain from a sale or exchange of such property is a capital gain. Losses from sales and exchanges of such property are not deductible, unless they result from personal casualties or thefts as discussed in Chapter 27.

Investment Property

Investment property is a capital asset, and a gain or loss from its sale or exchange is generally a capital gain or loss.

Gold, silver, stamps, coins, gems, etc., are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

Stocks, stock rights, and bonds (including stock received as a dividend) are capital assets except when held for sale by a securities dealer. See the discussion under *Losses on Small Business Stock,* in Publication 550.

Worthless corporate stocks or other securities with interest coupons or in registered form, which became worthless during the tax year, are treated as though they were capital assets sold on the last day of the tax year. To determine whether they are long-term or short-term capital assets, you are considered to have held the stocks or securities until the last day of the year in which they became worthless. See *Holding Period,* later.

If you are a cash method taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you may deduct these payments as losses in the years you actually make the payments. Do not deduct them in the year the stock became worthless.

Discounted debt instruments. Treat your gain or loss on the sale, redemption, or retirement of a bond or other evidence of indebtedness originally issued at a discount as follows.

Treat gains on ***short-term federal, state, or local government obligations*** as ordinary income up to the ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than one year from the date of issue. However, this treatment does not apply for state or local government obligations the interest on which is exempt from tax. Any gain in excess of the ratable share of the acquisition discount is capital gain. Any loss is capital loss. Acquisition discount is the excess of the stated redemption price at maturity over your basis in the obligation. The stated redemption price includes any interest payable at maturity. The ratable share of the acquisition discount is the amount that bears the same ratio to the discount as the number of days you held the obligation bears to the number of days after the date you acquired the obligation and up to and including the date of maturity. Alternatively, you may elect to figure the daily portion of the acquisition discount under the constant interest method. See Publication 550 for more information about making this irrevocable election.

Treat gains on ***short-term nongovernmental obligations*** (whether or not tax exempt) as ordinary income up to the ratable share of original issue discount. This treatment applies to obligations that are not short-term governmental obligations, as described above, and that have a fixed maturity date of not more than one year from the date of issue. The ratable share of OID is the amount that bears the same ratio to the discount as the number of days you held the obligation bears to the number of days after the date of original issue up to (and including) the date of its maturity. Alternatively, you may elect to figure the daily portion of the OID under the constant interest method on the basis of the obligation's issue price. See *Discount on Short-Term Obligations,* in Publication 550, for more information about making this irrevocable election.

Long-term debt instruments originally issued after 1954 by a government or political subdivision before July 2, 1982, or by a corporation before May 28, 1969. If you sell or redeem for a gain one of these debt instruments, the part of your gain due to the OID is interest income at the time of the sale or redemption. The balance of the gain is capital gain. If, however, there was an intention to call the debt instrument before maturity, the entire amount of OID is treated as ordinary income at the time of sale. This treatment of taxable gain also applies to corporate instruments issued after May 27, 1969, under a written commitment that was binding on that date and thereafter.

Original Issue Discount (OID) is the difference between the issue price (initial offering price to the public) of a long-term debt instrument and its principal amount (stated redemption price at maturity), if it amounts to at least one-fourth of 1% (.0025) of the stated redemption price multiplied by the number of full years from the date of original issue to maturity. All long-term instruments that pay no interest prior to maturity are presumed to be issued at a discount. See Chapter 8 for more information.

Long-term corporate debt instruments issued after May 27, 1969, and government instruments issued after July 1, 1982. If you hold one of these debt instruments, you must include a part of the OID in your gross income each year. See Chapter 8 for information about the OID that you must report on your tax return. Your basis in the instrument is increased by the amount of OID you have included in your gross income.

If you sell or exchange a debt instrument before it reaches maturity, your gain on the sale is a capital gain, provided you held the debt instrument as a capital asset. Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or exchanged that instrument.

However, if when the instrument was originally issued there was an intention to call it before its maturity, the gain on the sale of the instrument is ordinary income to the extent of the entire OID reduced by any amounts of OID previously includible in your income. The rest of the gain is capital gain.

See Publication 550 for more information about the tax treatment on the sale or redemption of discounted debt instruments.

Tax-exempt state and local government bonds. Any gain from market discount is taxable as a capital gain on disposition or redemption of these bonds issued before July 19, 1984. You figure the market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders.

Your adjusted basis at the time of disposition of tax-exempt state and local government bonds issued after September 3, 1982, and acquired after March 1, 1984, is figured by adding accrued OID to your basis. You must accrue OID on tax-exempt obligations under the same method used for OID on corporate obligations issued after July 1, 1982. You must also accrue OID on any stripped tax-exempt bond, or on a stripped coupon from such obligation, that you buy or sell after October 22, 1986, to determine its adjusted basis when you dispose of it. OID on tax-exempt obligations remains nontaxable. See Publication 550 for more information about determining the basis of these obligations.

Notes of individuals. If the evidence of indebtedness you bought at a discount was issued by an individual, its retirement generally will not be given capital gain treatment. But if you sell the discounted instruments to someone other than the original borrower, any gain is a capital gain. In figuring your adjusted basis in the note, do not reduce your original basis by any interest payments or by the part of the principal payments you received that is taxable discount income.

Example. You bought, for $6,000, a note of an individual on which $10,000 was still owed. You receive principal payments totaling $4,000, and then sell the note to someone other than the original borrower for $3,800. Only 60% ($6,000/$10,000) of the $4,000 is a return of your investment. The balance is discount income. You reduce your cost by $2,400 ($4,000 × 60%) to figure your adjusted basis. Your capital gain is $200, figured as follows:

Selling price of note		$3,800
Minus adjusted basis of note:		
Cost of note	$6,000	
Minus return on investment	2,400	3,600
Capital gain		$ 200

OID on obligations issued by individuals. The OID rules discussed in Chapter 8 apply to obligations issued by individuals after March 1, 1984. The OID rules will not apply to loans between individuals in amounts of $10,000 or less (including the outstanding amounts of prior loans) if the lender is not in the business of lending money, except if a principal purpose of the loan is to avoid federal tax.

Obligations issued in bearer form. Generally, any loss on a registration-required obligation held in bearer form is not deductible, and any gain on the sale or other disposition of such obligation is ordinary income, unless the issuer was subject to a tax on the issuance of the obligation.

A registration-required obligation is any obligation except:

1) An obligation issued by a natural person.

2) An obligation not of a type offered to the public.
3) An obligation that has a maturity at the date of issue of not more than 1 year.
4) An obligation issued before 1983.

Bad Debts

If someone owes you money and you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless. For a bad debt to qualify for the deduction, there must be a true creditor-debtor relationship between you and the person or organization that owes you the money. There must be a legal obligation to pay you a fixed sum of money. You must realize a loss because of your inability to collect the money owed to you.

Bad debts that you did not get in the course of operating your trade or business are nonbusiness bad debts. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partially worthless nonbusiness bad debt.

Nonbusiness bad debts are deducted only as short-term capital losses on Schedule D (Form 1040), *Capital Gains and Losses.* There are limits on how capital losses may be deducted. For a discussion of these limits, see Chapter 18.

For more information on the deduction for bad debts, see Publication 548, *Deduction for Bad Debts.*

Losses on Small Business Stock

You are allowed to deduct as an ordinary loss, rather than as a capital loss, your loss on the sale, exchange, or worthlessness of certain stock you own in a small business corporation or certain stock in a small business investment company. Gain on this stock is capital gain and is reported on Schedule D (Form 1040) if the stock is a capital asset in your hands. See Publication 550.

Holding Period

If you sold or traded investment property, you must determine whether the gain or loss is a short-term or long-term capital gain or loss.

Character of gain or loss. It is important for you to properly distinguish or classify your gains and losses as either ordinary or capital gains or losses and as either short-term or long-term gains or losses. These distinctions are essential to correctly arrive at your net capital gain or loss. The correct classification of your gains and losses is important for determining the limit on capital losses. For information about determining whether your gain or loss was an ordinary gain or loss or a capital gain or loss, see the discussion under *Capital or Ordinary Gain or Loss,* earlier in this chapter. For more information about figuring your capital gain income and determining your allowable capital loss, see Chapter 18.

Property acquired before 1988. If you held investment property ***more than 6 months,*** your gain or loss is a long-term capital gain or loss. If you held the property ***6 months or less,*** your gain or loss is a short-term capital gain or loss.

Property acquired after 1987. If you hold investment property ***more than one year,*** your gain or loss is a long-term capital gain or loss. If you hold the property ***one year or less,*** your gain or loss is a short-term capital gain or loss.

To figure how long you held the investment property, start counting on the day after the day you acquired the property. The same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you disposed of the property is part of your holding period.

Example. If you bought an asset on February 4, 1988, you should start counting on February 5. If you sell the asset on February 4, 1989, your holding period is not more than one year, but if you sell it on February 5, 1989, your holding period is more than one year and you will have a long-term capital gain or loss.

Securities traded on established market. For securities traded on an established securities market, the holding period is measured by using the ***trading dates*** as the dates bought and sold and not the settlement dates. Gain or loss is also recognized on the trading date of the sale and not on the settlement date.

Example. You are a cash method, calendar year taxpayer. You sold stock at a gain on December 29, 1988. According to the rules of the stock exchange, the sale was closed by delivery of the stock 5 trading days after the sale, on January 6, 1989. You received payment of the sales price on that same day. Report your gain on your 1988 return, even though you received the payment in 1989. The gain is long term or short term depending on whether you held the stock more than one year. Your holding period ended on December 29. If you had sold the stock at a loss, you would also report it on your 1988 return.

Nontaxable trades. If you acquire investment property in a trade for other investment property and your basis for the new property is figured, in whole or in part, by your basis in the old property (see Chapter 15), your holding period of the new property begins on the day following the date you acquired the old property.

Gifts. If you receive a gift of property and your basis in it is figured by using the donor's basis, your holding period includes the donor's holding period. See Chapter 15.

Inheritance. If you inherit investment property and your basis for it is determined with reference to its fair market value at the date of the decedent's death, or at the alternate valuation date, or as the decedent's adjusted basis (for appreciated property), your gain or loss on any later disposition of such property is treated as a long-term capital gain or loss. You are considered to have held the property for more than one year (more than 6 months for property acquired before 1988), even if you dispose of it within one year (within 6 months for property acquired before 1988) after the decedent's death. See Publication 551, *Basis of Assets.*

Real property. To figure how long you have held real property bought under an unconditional contract, start counting on the earlier of the day after you received title to it, or the day after you took possession and assumed the burdens and privileges of ownership. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Mutual fund stock. If you received exempt-interest dividends on mutual fund stock that you held 6 months or less and sold at a loss, you may not claim the part of the loss that is equal to or less than the exempt-interest dividends. You must report the rest of the loss as a short-term capital loss. A holding period shorter than 6 months may apply, if provided under regulations prescribed by the Internal Revenue Service. The mutual fund should be able to tell you if a shorter period applies. See Publication 564, *Mutual Fund Distributions,* for more information.

Real estate investment trust. If you received a capital gain distribution on real estate investment trust stock that you held 6 months or less and sold at a loss, you must report as a long-term capital loss the part of the loss that is equal to, or less than, the long-term capital gain distribution. This rule does not apply to dispositions of stock under a periodic liquidation plan. See Chapter 9 for information on capital gain distributions.

Automatic investment service and dividend reinvestment plans. If you take part in a plan to buy stock through a bank or other agent, the date the bank or other agent buys the stock is your purchase date for figuring the holding period of that stock. If a full share or part of a share was bought over a period of more than one purchase date, the holding period is a split holding period. A part of the full share or part of a share is considered to have been bought on each date stock was bought by the bank or other agent with the proceeds of available funds.

Nontaxable stock dividend. The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock.

Nontaxable stock rights. Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock.

17. Selling Your Home

This chapter explains how you report gain from selling your home, and how you may postpone the tax on part or all of your gain on the sale of your home. You must use Form 2119 to report gain from selling your main home, whether or not you buy another main home.

Treatment of Gain

If you sell your main home, you may be able to postpone paying tax on some or all of the gain from the sale. If you buy a new home, and the purchase price of the new home is at least as much as the adjusted sales price of the old home, you may be able to postpone the tax on all the gain from the sale. If you do not buy a new home, or if the purchase price of the new home is less than the adjusted sales price of the old home, you will be subject to tax on some or all of the gain, unless you qualify to exclude the gain as explained later.

Any gain not postponed is long-term or short-term capital gain, depending on how long you owned your home.

For tax years beginning after 1986, the 60% long-term capital gains deduction has been repealed. You must include all capital gains, including capital gains on the sale or exchange of your main home, with your ordinary income. For more information on capital gains and losses, get Publication 544, *Sales and Other Dispositions of Assets*.

Purchase price at least as much as sales price. Your entire gain on the sale or exchange of your home is not taxed at the time of the sale if, within 2 years before or 2 years after the sale, you buy and live in another home that costs at least as much as the adjusted sales price (described later) of the old home. If you are on active duty in the armed forces, or if your tax home is outside the United States, the 2-year period may be suspended. See *Members of the armed forces* and *People abroad*, later.

Purchase price less than sales price. If the purchase price of your new home is less than the adjusted sales price of your old home, and you buy and live in the new home within the time period given above, the gain taxed in the year of the sale is the lesser of:

1) The gain on the sale of the old home, or
2) The amount by which the adjusted sales price of the old home is more than the purchase price of the new home.

Postponing the gain. You *must* postpone the gain if you replace your old home within the required period. If you have more than one home, you postpone the gain only on the sale of your *main* home.

The tax on the gain is postponed, not forgiven. You subtract any gain that is not taxed in the year you sell your old home from the cost of your new home. This gives you a lower basis in the new home. If you sell the new home in a later year and again replace it, you may continue to postpone any tax on your gain.

Example. You sold your home in 1988 for $50,000 and had a $5,000 gain. Within 2 years, you bought another home for $60,000, which is more than you received for the old one. The $5,000 gain will not be taxed in 1988 (the year of sale), but you must subtract it from the $60,000. This makes the basis of your new home $55,000. If you later sell the new home for $66,000, and do not buy and live in a replacement home within the required time, you will be subject to tax on the $11,000 gain ($66,000 minus $55,000) in the sale year.

You need not use the same funds received from the sale of your old home to buy or build your new home. For example, you may use less cash and increase the amount of your mortgage loan.

Loss on sale. You may *not* deduct a loss on the sale or exchange of your home. The loss has no effect on the basis of your new home.

Refinancing. If you refinanced your home in 1988, see Chapter 25.

Basis

Basis is a way of measuring your investment in property for tax purposes. Whether you bought your home, hired a contractor to build it for you, built it yourself, or received it in another way, it is important that you know its basis. The basis of property you buy is usually the cost or purchase price. You must know its adjusted basis to figure gain or loss when you sell or otherwise dispose of your home. You also must know the adjusted basis at the time of a casualty to determine your deductible loss from the casualty. If you change your home to rental or business use, your depreciation is based on the fair market value of the home or its adjusted basis at the time of the change, whichever is less.

Adjusted basis. This is your original basis *increased* or *reduced* by certain amounts. You must increase your basis by the cost of improvements, additions, and other capital items. You must reduce the basis by any deductible losses from fire or other casualty, payments you receive for any easements or rights-of-way you give up, and any depreciation you claimed. If you claimed any residential energy credit before 1986 (or carried over any part to 1986 or 1987) you must decrease the basis of your home by the amount of the credit allowed if you added the cost of the energy items to the basis of your home. You may not add to your basis certain settlement fees or closing costs such as "points," fire insurance premiums, mortgage insurance premiums, or charges for services concerning occupancy of the house.

Improvements add to the value of your home, prolong its life, or adapt it to new uses. Improvements, which you add to the basis of your property, should not be confused with repairs, which you do not add to the basis. *Repairs* just maintain your home in good condition. They do not add to its value or prolong its life.

Examples. Putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, putting on a new roof, or paving your driveway are improvements that you add to basis. On the other hand, repainting your house inside or outside, fixing your gutters or floors, mending leaks or plastering, and replacing broken window panes are examples of repairs.

Recordkeeping. You should save receipts and other records for all improvements, additions, and other items that affect the basis of your home. Ordinarily, you must keep records for 3 years after the due date for filing your return for the tax year in which you sold, or otherwise disposed of, your home. But if you use the basis of your old home in figuring the basis of your new one, such as when you sell your old home and postpone tax on your gain, you should keep those records as long as they are material for tax purposes.

For more information on basis and adjusted basis, see Chapter 15.

Main Home

Usually, the home in which you live is your main home. The home that you sell and the one you buy to replace it must both qualify as your main home. *Property partly used as your home* and *Home changed to rental property* are discussed later in this chapter.

A houseboat or mobile home may be your main home.

Cooperative apartments. If you own a co-op apartment, that apartment may be your main home. Your basis in the apartment is usually the cost of your stock in the co-op housing corporation, which may include your share of a mortgage on the apartment building.

Condominiums. A condominium home or apartment may be your main home. Your basis is your cost, which also may include your share of the mortgage, if any, on the common elements of the development or structure.

Furniture, appliances, and similar items that are not fixtures (permanent parts of the property) generally are not part of your main home.

Land. If you sell the land on which your main home is located, but not the house itself, you may not postpone any gain you have from the sale of the land. For example, you sell the land on which your main home is located. Within the replacement period, you buy another piece of land and move your house to it. This sale is not considered to be a sale of your main home and you may not postpone any gain on the sale. This rule applies to sales after March 27, 1983.

More than one home. If you have more than one home, only the sale of your main home qualifies for postponing the tax. For example, you own and live in a house in town and also own beach property, which you use in the summer months. The town property is your main home; the beach property is not.

If you have two homes and live in both of them, your main home is the one you live in most of the time.

If you own a house, but live in another house for which you pay rent, the rented home is your main home. But if a house you own is your main home, you may temporarily rent it out before its sale without changing its character as your main home.

Old Home

To figure the gain on the sale of your old home, you must know the selling price and the amount realized.

Your gain is the amount realized minus the adjusted basis of the home.

Amount realized. The amount realized is the selling price minus selling expenses.

Selling price. The selling price is the total amount you receive for the property, including money, all notes, mortgages, or other debts that are part of the sale, and the fair market value of other property you receive.

If you have to sell your home because of a job transfer, and your employer pays you for a loss in value of your home, do *not* include the payment as part of the selling price. Include it in your gross income as compensation for services on line 7 of Form 1040.

Selling expenses include commissions, advertising, and legal fees. Loan charges paid by the seller, such as loan placement fees or "points," are usually a selling expense.

Moving expenses. You may deduct some expenses of selling a home as moving expenses. See Chapter 28.

Adjusted sales price. The adjusted sales price of the old home is used to figure the part of the gain on which tax is postponed. The adjusted sales price is the amount realized minus any fixing-up expenses you might have. Compare the adjusted sales price with the cost of the new home to find the gain on which tax is postponed.

Fixing-up expenses are decorating and repair expenses you paid to sell the old home and must:

1) Be for work done during the 90-day period ending on the day you sign the contract to sell, and
2) Be paid within 30 days after the sale, and

3) Not be deductible in arriving at your taxable income, and

4) Not be used in figuring the amount realized, and

5) Not be capital expenses or improvements.

Caution: You consider fixing-up expenses ***only*** in finding the gain on which tax is postponed. You may ***not*** deduct them in figuring the actual profit on the sale of the old home.

Example. Your old home had a basis of $45,000. You signed a contract to sell it on December 16, 1987. On January 6, 1988, you sold it for $61,400. Selling expenses were $5,000. During the 90–day period ending December 16, 1987, you had the following work done. You paid for the work on February 1, 1988—within 30 days after the sale.

Inside and outside painting	$800
New venetian blinds and new water heater	$900

Within the required time you bought and lived in a new home that cost $54,600. The amount of gain on which tax is postponed, is not postponed, and the basis of your new home are as follows:

1) Selling price of old home	$61,400	
2) Minus: Selling expenses	5,000	
3) Amount realized		$56,400
4) Basis of old home	$45,000	
5) Add: Improvements (blinds and heater)	900	
6) Adjusted basis of old home		45,900
7) Gain on old home [(3) minus (6)]		$10,500
8) Amount realized on old home	$56,400	
9) Minus: Fixing-up expenses (painting)	800	
10) Adjusted sales price		$55,600
11) Cost of new home		54,600
12) Gain not postponed [(10) minus (11)]		$ 1,000
13) Gain postponed [(7) minus (12)]		$ 9,500
14) Cost of new home		$54,600
15) Minus: Gain postponed [item (13)]		9,500
16) Basis of new home		$45,100

Trading homes. If you trade your old home for another home, the trade is treated as a sale and a purchase.

Example. You owned and lived in a home that had a basis of $41,000. A real estate dealer accepted your old home as a trade-in and allowed you $50,000 toward a new house priced at $80,000. You are considered to have sold your old home for $50,000 and to have had a gain of $9,000 ($50,000 minus $41,000). Because you replaced it with a new home costing more than the sales price of the old one, you must postpone the tax on the gain. The basis of your new home is $71,000 ($80,000 cost minus $9,000 gain that is not currently taxed).

If the dealer had allowed you $27,000 and assumed your unpaid mortgage of $23,000 on your old home, $50,000 would still be considered the sales price (the trade-in allowed plus the mortgage assumed).

Property partly used as your home. You may use your property partly as your home and partly for business or to produce income. Examples are a working farm on which your house is located, an apartment building in which you live in one unit and rent out the others, or a store building with an upstairs apartment in which you live. If you sell the whole property, you postpone only the tax on the part used as your home. This includes the land and outbuildings, such as a garage for the home, but not those for the business or the production of income. For more information, see *Property partly used as your home* in Publication 523.

Business use of your home. If, in the year of sale, you deduct expenses for the business use of your home, you cannot postpone the tax on the gain on the part of the home used for business. In figuring the amount of gain you may postpone, you must make an allocation for the business-use part of the home. This allocation is shown under *Business use of your home* in Publication 523.

Home changed to rental property. You may not postpone tax on the gain on rental property, even though it was once used as your home. The rules explained in this chapter generally will not apply to its sale or exchange. Gains are taxable and losses are deductible, as explained in Chapter 16. The basis of the property is determined as explained under *Property Changed to Business or Rental Use* in Chapter 15.

If you temporarily rent out your old main home before selling it, or your new main home before living in it, as a matter of convenience, or for some other nonbusiness purpose, any gain on the sale of the property will qualify for treatment under the rules explained in this chapter. For information on how to treat the rental income you receive, see Chapter 10.

If you place your home with a real estate agent for rent or sale and it is not rented, it will not be considered business property or property held for the production of income. The rules explained in this chapter will apply to the sale of the home.

Condemnation. If your home is condemned for public use, and you have a gain, you may postpone the tax on the gain under the rules explained in this chapter or under those discussed in Publication 549, *Condemnations and Business Casualties and Thefts.*

Gain on casualty. The tax on a gain from fire, storm, or other casualty cannot be postponed under the rules explained in this chapter, but may be postponed under the rules in Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*

Time for Replacement

If you sold your old home during 1988, the time allowed to replace your old home, occupy your new home, and not be required to recognize gain on the sale is a 48–month period. That is, if, within 2 years before or 2 years after you sell your old home, you buy or build and live in another home, you may be able to postpone the tax on the gain on the sale of your old home.

Example. You buy and move into a new home that you use as your main home on April 20, 1988, before you sell your old home. You have until April 20, 1990, a period of 24 months (unless the time is suspended, explained later) to sell your old home and postpone tax on any gain.

Occupancy test. You must physically live in the replacement home as your main home within the required period. If you move furniture or other personal belongings into the new home but do not actually live in it, you have not met the occupancy test.

No added time beyond the specified periods is allowed for replacement and occupancy. There may be a suspension of time, discussed later, for certain members of the armed forces and people abroad. If you had a gain on the sale of your old home and did not buy or build and live in another home within the specified replacement period, you have no more time for replacement or occupancy. This rule applies even if you are kept from doing so by conditions beyond your control, such as the destruction of the replacement home while it is being built.

If you do not replace the home in time, you must file an amended return for the year of sale and report the entire gain on the sale of your old home. Also, if you began building your new home within the specified period but for any reason were unable to live in it within 2 years, you do not have any more time for occupancy and must report your entire gain on an amended return for the year of the sale.

Members of the armed forces. The replacement period after the sale of your old home is suspended while you serve on extended active duty in the armed forces. You are on extended active duty if you are serving under a call or order for an indefinite period or for more than 90 days. The suspension applies only if your service begins before the end of the 2–year period. This time plus any period of suspension is limited to 4 years (8 years in certain cases) from the sale of your old home. For more information, see *Members of the armed forces* in Publication 523.

Overseas military assignment. The replacement period is suspended while you are stationed outside the United States. The replacement period may also be suspended while you are required to live in on-base quarters following your return from a tour of duty outside the United States. In this case, it will be suspended if you are required to live on base because you are stationed at a remote site where the Secretary of Defense has determined adequate off-base housing is not available. If you sold your house after July 18, 1984, the replacement period will not expire until one year after the last day you are stationed outside the United States, or the last day you are required to reside in Government quarters on base. The replacement period, plus any period of suspension, is limited to the date which is 8 years after the date of the sale of your old home.

Under prior law, the replacement period ended on the last day you were stationed outside the United States or the last day you were required to live in Government quarters. If you qualify for this additional one-year extension and have already filed a 1984, 1985, or 1986 income tax return reporting gain from the sale of a home that is further postponed by this change, you may file Form 1040X, *Amended U.S. Individual Income Tax Return,* to claim a refund. You can postpone the gain on the sale of a home for the additional year or defer gain on the sale of the old residence if a new home is purchased and used within the replacement period.

People abroad. The replacement period after the sale of your old home is suspended while you have your tax home (place where you live and work) outside the United States. This suspension applies only if your stay abroad begins before the end of the 2-year replacement period. The replacement period, plus the period of suspension, is limited to 4 years from the date of sale of your old home. For more information, see *People abroad* in Publication 523. For a discussion of tax home, see Chapter 19.

New Home

You use the purchase price of your replacement home to find the gain taxed and the gain on which tax is postponed on the sale of your old home. Purchase price includes costs incurred within the 48–month replacement period for the following items:

1) Buying or building the home,
2) Rebuilding, and
3) Capital improvements or additions.

You may not consider any costs incurred before or after the 48–month period. However, if you are a member of the armed forces you may include in the purchase price any costs incurred during the suspension period.

Debts on the new property. The price of a new home includes debts it is subject to when you buy it and the face amount of your notes or other liabilities (purchase money mortgage or deed of trust) that you give for it.

Zero or low interest mortgage. If you buy a home and the mortgage is at a low rate of interest, or there is no interest, a computation will be required to reflect interest at a proper rate. Generally, a computation is required if the interest rate on the mortgage is less than the applicable federal rate. For information, see Publication 537, *Installment Sales.*

Temporary housing. If a builder gives you temporary housing while your new home is being finished, you must subtract the rental value of the temporary housing from the total contract price in arriving at the cost of the new home.

Settlement fees or closing costs. You probably paid an amount in addition to the contract price of the property for settlement fees or closing costs. Several expenses connected with the purchase are not included in the purchase price of the home, but are divided between the buyer and seller, according to the sales contract, local custom, or understanding of the parties.

If you itemize your deductions, you may deduct some of these costs, such as real estate taxes, mortgage interest, and "points" that are deductible as interest, in the year you buy the house. See Chapters 24 and 25. You may add other costs, such as attorney fees and transfer taxes, to the basis of your home. See Chapter 15.

You may not deduct, or add to your basis, certain settlement fees or closing costs. These include "points" or loan origination fees that are not deductible as interest, fire insurance premiums, FHA mortgage insurance premiums, charges for the use of utilities, rent for occupancy before closing, and other fees or charges for services concerning occupancy of the house.

Investment in retirement home. You have not bought a replacement home if you sell your home and invest the amount you receive for it in a retirement home project that will give you living quarters, personal care, etc., but which does not give you any legal interest in the property. Therefore, you must include in income any gain on the sale of your home. However, if you are 55 or older, see *Exclusion of Gain,* later in this chapter.

Allocation between you and your spouse. Sometimes either you or your spouse may own the old home separately, but title to the new one is in both your names as joint tenants. Or, you may own the old home as joint tenants and either you or your spouse may own the new home separately. In such cases the gain from the sale of the old home may be postponed. The postponed gain, which reduces the basis of the new home, may be divided between you and your spouse if:

1) Both of you use the old and new homes as your main home, and
2) Both of you sign a statement that says: "We agree to reduce the basis of the new home(s) by the gain from selling the old home(s)." Both of you must sign the statement. The statement (consent) can be made in the bottom margin of Form 2119, *Sale of Your Home,* or on an attached sheet.

If both of you do not sign the statement, you must figure gain on the sale of the old home in the regular way without allocation.

Caution: As this publication was being prepared for print, Congress was considering legislation that would allow the allocation without the signed consent of one spouse if that spouse dies before the new home is occupied and the surviving spouse consents and uses the new home as his or her main home. For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Example 1. You sell, for an adjusted sales price of $48,000, the main home of yourself and your spouse, which you own individually, and which has an adjusted basis of $36,000. Within 2 years after the sale you and your spouse contribute $25,000 each from your separate funds to buy your new main home—title to be held jointly. If you and your spouse sign the statement (consent) to allocate the basis of the new home, the gain on the sale of your old home will be postponed, and you and your spouse will each have an adjusted basis of $19,000 in the new home. If you do not sign the statement, your entire gain of $12,000 on the sale of the old home will be taxed, because the adjusted sales price of the old home exceeds your portion of the cost of the new home. Both you and your spouse will then have a basis of $25,000 each in the new home.

Example 2. Assume in Example 1 that you and your spouse each own a half interest in your old home, and your spouse buys your new home with separate funds and takes title individually. If you both sign the statement (consent), the $12,000 gain from the sale of your old home will be postponed and your spouse will have an adjusted basis of $38,000 in the new home. If you do not sign the statement, you will be taxed on your share of the gain on the old home, but your spouse will postpone recognition of his or her share of the gain, because it was reinvested in the new home. Your spouse's basis in the new home will be $44,000 ($50,000 cost minus $6,000 postponed gain).

Example 3. Assume in Example 1 that you own your old home individually and your spouse owns your new home individually. If you and your spouse sign the statement, the gain of $12,000 from the sale of your old home will be postponed and your spouse will have an adjusted basis in the new home of $38,000. If you do not sign the statement, your entire gain will be taxed and your spouse's basis in the new home will be $50,000.

Separate homes replaced by single home. The tax on your and your spouse's gains from the sales of homes that had been your separate main homes before your marriage will be postponed if:

1) You buy a new main home for more than the combined adjusted sales prices of the old homes, and
2) You and your spouse each contribute one-half of the purchase price and take joint title to the new home.

Report the sales of the old homes on separate Forms 2119. Divide the purchase price of the new home between you and your spouse.

Title to new home not held by either you or your spouse. If you invest the amount you receive from the sale of the old home in a new home in which neither you nor your spouse hold any legal interest, title being held by someone else, such as your child, you may ***not*** postpone the tax on the gain on the sale of the old home.

Home replaced by two homes by spouses living apart. The postponement provisions apply separately to the gains realized by you and your spouse from the sale of your main home if you have agreed to live apart and you each bought and lived in a separate replacement home.

Example. You and your spouse bought a home in 1983. You owned the property as tenants by the entirety and used it as your main home. In 1988, you agreed to live apart, and sold the home for $60,000. The gain on the sale was $20,000. Under state law, each of you is entitled to half the proceeds of the sale. Therefore, each of you had a $10,000 gain from the sale of your home. Before the end of 1988, you and your spouse individually bought and lived in separate homes. The cost of each new home, $52,000 and $56,000 respectively, was more than your respective shares of the adjusted sales price of the old home. You and your spouse must postpone the tax on the $20,000 gain on the old home. Your new home has an adjusted basis of $42,000 ($52,000 minus half of $20,000 gain postponed). Your spouse's new home has an adjusted basis of $46,000 ($56,000 minus half of $20,000 gain postponed).

You each report the sale of your home on Form 2119 as if two separate properties were sold. You report half of the sales price and your spouse reports half of the sales price.

See *If you are divorced after filing a joint return,* later.

Inheritance. If you inherit or receive any part of your new home as a gift, you cannot use the value of that part to determine the cost of the new home in figuring the gain on the sale of your old home on which tax is postponed. You include the basis of that part, however, in the adjusted basis used in figuring gain when you sell the new home.

Example. Your father died in 1988 and you inherited his home. Its basis to you is $42,000. You spent $14,000 to modernize the home.

resulting in a basis to you of $56,000. Assume that within 2 years of inheriting your father's home you sell your old home for $45,000, at a gain of $5,000. You have fixing-up expenses of $200 on your old home.

To find the amount of gain to be taxed in the year of the sale, you compare the adjusted sales price of the old home, $44,800 ($45,000 minus $200), with the $14,000 you invested in your new home. Therefore, the $5,000 gain is fully taxed, because the adjusted sales price of the old home is more than the amount you paid to rebuild your new home. You do not use the value of your inherited property ($42,000) to determine the amount you paid for your new home.

No double deduction. You may not decrease the amount realized on the sale of your home by the real estate commission or other expenses you deduct as a moving expense. You may not increase the basis of a new home by the attorney's fees or other expenses you deduct as moving expenses. For more information, see Chapter 28.

Holding period. If you postpone tax on any part of the gain on the sale of your old home, you will be considered to have owned your new home for the combined period you owned both the old and the new homes. See Chapter 16 for more information on holding periods.

Second sale during replacement period. If you sell your new main home within 2 years after the sale of your old home and any part of the gain was not recognized, you generally may not postpone tax on the gain on the sale of the new home.

Example. You sold your main home in March 1987 at a gain. You postponed tax on the gain because you bought a new home in April 1987 for at least as much as the adjusted sales price of the old home. You then sell your new main home in June 1988. Even if you buy or build another new main home within 2 years, you may not postpone tax on the June 1988 sale because it is within 2 years of the March 1987 sale.

Exception. This rule does not apply if you sell or exchange your main home because of a ***work-related move.*** If certain requirements are met, you may postpone the gain from the sale of more than one main home during the replacement period. These requirements relate to the distance between your new work place and your old home, and to the length of time you must work full-time after the move. The requirements are explained in Chapter 28.

More than one new home. If during the replacement period you buy or build more than one main home, only the last one bought or built in the period may be treated as the ***new home*** in figuring whether you may postpone the tax on the gain from the sale of the old home.

Example. You sold your old main home on March 15, 1987, at a gain. You bought a new main home on June 3, 1987. On February 3, 1988, you bought another new main home. In figuring whether you may postpone tax on the gain on your old home, compare the cost of the new home you bought on February 3, 1988, with the adjusted sales price of the old home sold on March 15, 1987.

Exception. If you sell your home because of a work-related move to which the exception discussed above applies, you should treat this home as the new home in deciding whether you can postpone tax on the gain from the sale of your old home.

Example. You buy more than one new home within the two year replacement period as shown below:

January 1988	You sell your house in **Chicago** at a gain.
February 1988	You buy a more expensive house in **Memphis.**
March 1989	You sell your house in **Memphis** due to a transfer required by your employer.
March 1989	You buy a more expensive house in **New York City.** The move meets the requirements for a moving expense deduction.

When you complete Form 2119 for the sale of your house in Chicago, compare the cost of the home bought in Memphis with the adjusted sales price of the house in Chicago, even though you bought another new main home within two years (New York City in March 1989).

Continued postponement of gain. If you bought your present home in a way that lets you postpone tax, you continue to postpone the tax if you replace your present home under the rules explained in this chapter.

Example. In 1973 you sold your home, which you had owned since 1963, and bought a new one. The tax on the gain was postponed and the basis of the home you bought in 1973 was reduced by the gain you postponed. This year you sold the home you bought in 1973 and bought a more expensive one. You may postpone tax on the gain from selling the home you bought in 1973.

How to Report

If you sold or exchanged your home during the year, report the details of the sale as explained here, even if the tax is postponed on all of the gain or you have not purchased a new home.

Report sale in year sold on Form 2119. Use Form 2119, *Sale of Your Home*, to report the sale of your old home and any purchase of a new one. See Chapter 38 for an example of a filled-in Form 2119.

You should keep a copy of your Form 2119, along with your tax records for the year, for future proof of basis of the replacement home.

New home purchased and lived in before return for year of sale filed. If you buy a new home before you file a return for the year of sale of your old home and within the replacement period, and it costs as much or more than the sales price of the old home, complete Form 2119 and attach it to your return. Show the price of the new home, the date you first lived in it, how you figured the gain on which tax is postponed, and the adjusted basis of your new home.

If you buy and live in the new home before you file your return for the year of sale of your old home and within the replacement period, and it costs less than the adjusted sales price of the old home, you must complete Form 2119 and attach it to your return. Show the gain reported this year on Schedule D.

New home purchased and lived in after return for year of sale is filed, but within replacement period. If you plan to replace your home, but have not done so, you must report the sale on Form 2119 and attach it to your return for the year of the sale. Complete lines 1 and 2 and Part II only. When you buy and live in your new home within the replacement period, and it costs as much or more than the adjusted sales price of the old home, you should notify the Director of the Internal Revenue Service Center where you normally file your tax return. You notify the Service by completing and filing a second Form 2119 giving the date you first lived in the new home and its cost. Your address, signature, and the date are required on this Form 2119 if you do not file the form with a tax return. If the Form 2119 is for you and your spouse, you both must sign it.

If the new home costs less than the adjusted sales price of the old home, and you buy and live in the house within the replacement period, you should file an amended return (Form 1040X) for the year of the sale. Attach a completed Form 2119 and Schedule D showing the gain you must report. You will have to pay interest on any additional tax due on the gain you report on your amended return.

New home not purchased within replacement period or old home not replaced. If you do not plan to replace your old home, you must complete Form 2119 and Schedule D and attach them to your tax return for the year of the sale. The entire gain is taxable unless you are eligible to exclude some or all of the gain. See *Exclusion of Gain*, later.

If you postponed gain on the sale of your old home and do not buy or build and live in a new home within the replacement period, you must file a second Form 2119 and an amended return (Form 1040X) for the year of the sale. Include a Schedule D to report your gain and any other appropriate schedule. For example, you would have to include Form 6252 to report an installment sale. You will have to pay interest on the additional tax due on the gain reported on your amended return.

If you are divorced after filing a joint return on which you postponed reporting the tax on the gain on the sale of your home, but you do not use your share of the proceeds to buy or build a new home (and your former spouse does), you must file an amended joint return to report the tax on your share of the gain. If your former spouse refuses to sign the amended joint return, attach a letter explaining why your former spouse's signature is missing.

If you paid tax on the gain from the sale of your old home, and you buy or build and live in a new home within the replacement period, you should file a Form 1040X, amended return, for the year of sale of your old home. Complete a new Form 2119, and include it with your amended return. Report only the gain on which you cannot postpone the tax, and claim a refund of the rest of the tax.

Installment sale. You may report on the installment basis the part of the gain you may not postpone if the sale qualifies as an installment sale.

Statute of limitations. If you sell your home at a gain, the period during which you may have to pay tax on that gain will not run out until 3 years after you notify the Internal Revenue Service. To notify the Service, complete and file a second Form 2119 with the Service Center where you filed your return for the year you sold your home which shows one of the following:

1) That you replaced your old home, and how much the replacement home cost,

available

2) That you do not plan to buy a new home within the replacement period, or
3) That you did not buy a new home within the replacement period.

You should send with the second Form 2119, if needed, an amended return for the year in which you had the gain. On the amended return, include in your income the gain that you cannot postpone.

Real Estate Transactions

For tax years beginning after December 31, 1986, the law requires that transactions involving the sale or exchange of most residential real estate property be reported to the Internal Revenue Service by filing Form 1099–S, *Statement for Recipients of Proceeds From Real Estate Transactions.*

Caution: As this publication was being prepared for print, Congress was considering legislation that would prohibit real estate brokers from charging any customer separately for preparing Form 1099–S. For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Exclusion of Gain

You may exclude from your gross income some or all of your gain from the sale of your main home, if you meet certain age, ownership, and use tests at the time of the sale. You may choose to exclude gain only once for sales or exchanges after July 26, 1978.

Age, Ownership, and Use

You may choose to exclude from your gross income $125,000 of gain ($62,500 if you are married filing separately) on the sale or exchange of your main home if:

1) You were 55 or older on the date of the sale or exchange, and
2) You ***owned and lived in*** your main home for at least 3 years out of the 5–year period ending on the date of the sale or exchange, and
3) Neither you nor your spouse has excluded gain on the sale of a home since July 26, 1978.

For more information and examples, see *Exclusion of Gain* in Publication 523.

18. Reporting Gains and Losses

Important Change for 1988

Capital gain. If you have a capital gain, it is taxable at the same rate as your ordinary income.

This chapter discusses reporting capital gains and losses from sales, exchanges, and other dispositions of investment property. It covers the use of Schedule D (Form 1040) for figuring your net capital gain income or your deductible capital loss. For information on reporting sales of business property, see Publication 544, *Sales and Other Dispositions of Assets.*

Schedule D

Report capital gains and losses on Schedule D (Form 1040), *Capital Gains and Losses.* This schedule is also used to figure the limit on capital losses and to reconcile your Forms 1099–B, as discussed later.

Passive activity gains and losses may also have to be reported on Form 8582, *Passive Activity Loss Limitations.* In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

Form 1099–B transactions. If you sold property, such as securities, commodities, bonds, etc., through a broker, you should receive Form 1099–B, *Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions,* or an equivalent statement from the broker. Use the Form 1099–B or equivalent statement to complete line 1 of Schedule D (Form 1040).

Report the gross proceeds shown in Box 2 of Form 1099–B as the gross sales price in column (d) of either line 2a or line 9a of Schedule D (Form 1040), as applicable. However, if the broker advises you, in Box 2 of Form 1099–B, that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that ***net sales price*** in column (d) of either line 2a or line 9a of Schedule D (Form 1040), as applicable. If the net amount is entered in column (d), do not include the commissions and option premiums in column (e). Be sure to add all sales price entries in column (d) on line 2a and line 9a and enter the total on line 2b and line 9b.

Follow the Schedule D instructions for reporting any differences between line 1 and the total of lines 2b and 9b.

If the Form 1099–B you receive includes amounts derived from the sale or exchange of section 1256 contracts or straddles, or from hedging transactions, see Publication 550, *Investment Income and Expenses,* for more information about reporting these amounts.

If you are required to file a return, a negligence penalty (described in Chapter 1) may be imposed on you if this income is taxable and it has not been reported.

Form 1099–S transactions. If you sold or exchanged one-to-four-family real estate, you should receive Form 1099–S, *Statement for Recipients of Proceeds From Real Estate Transactions* from the settlement agent. One-to-four-family real estate is a structure designed for the occupancy of one to four families, such as a house, townhouse, duplex, or four unit apartment building. The gross proceeds from the sale or exchange are shown in Box 2 of Form 1099–S. If the building sold or exchanged was your principal residence, report any gain for that part of the property on Form 2119, *Sale of Your Home.* Otherwise, follow the Schedule D instructions for reporting these transactions.

Other transactions. Enter all sales of stocks, bonds, etc., on line 2a or line 9a of Schedule D (Form 1040), as applicable, whether or not you actually received a Form 1099–B. However, do not include real estate transactions on line 2a and line 9a. Follow the Schedule D instructions for reporting these transactions. Use either line 2c or line 9c of Schedule D (Form 1040), as applicable, to report gains and losses on other transactions for which you did not receive Form 1099–B.

If you had gains or losses from the disposition of **options,** including puts and calls, see Publication 550.

Sale expenses. Add any expense of sale such as broker's fees, commissions, state and local transfer taxes, and option premiums to the cost or other basis of your securities before making any entry in column (e) of either Part I or Part II of Schedule D (Form 1040), as applicable, unless you reported the net sales price amount in column (d).

For more information about the expenses of producing income, see Publication 550.

Short-term gains and losses. Gain or loss on the sale or trade of investment property held one year or less (6 months or less, if acquired before 1988) is a short-term capital gain or loss. Report it in Part I of Schedule D (Form 1040).

Property held for personal use. Gain on the sale or exchange of property held for personal use and held for one year or less (6 months or less, if acquired before 1988) is a short-term capital gain. Report it in Part I of Schedule D (Form 1040). Losses on sales or exchanges of property held for personal use are not deductible.

You combine your share of short-term capital gains or losses from partnerships, S corporations, or fiduciaries, and any short-term capital loss carryover, with your other short-term gains and losses to figure your net short-term capital gain or loss.

Long-term gains and losses. A gain or loss on the sale or trade of investment property held more than one year (more than 6 months, if acquired before 1988) is a long-term capital gain or loss. Report it in Part II of Schedule D (Form 1040).

Property held for personal use. Gain on the sale or exchange of property held for personal use and held more than one year (more than 6 months, if acquired before 1988) is a long-term capital gain. Report it in Part II of Schedule D (Form 1040). Loss on the sale or exchange of property held for personal use is not deductible.

You also report the following in Part II of Schedule D (Form 1040):

1) Capital gain distributions from regulated investment companies (mutual funds) and real estate investment trusts.
2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries.
3) Long-term capital loss carryovers.

The result from combining these items with your other long-term gains and losses is your net long-term capital gain or loss.

Capital gain distributions. You report capital gain distributions on line 13, Part II of Schedule D (Form 1040). If you do not need Schedule D to report any other capital gains or losses, enter your capital gain distributions for 1988 on line 14, Form 1040.

The total net gain or loss is then figured by combining your net short-term capital gain or loss with your net long-term capital gain or loss. Enter the result on line 18, Part III of Schedule D. If your losses are more than your gains, see also the discussion of *Capital Losses*, next.

Capital Losses

If you have a total net capital loss, you may be able to claim a capital loss deduction. You must first figure how much of the loss is allowable. Then you must figure how much of the loss you may deduct in the year of the loss and how much of it you carry over and use in future tax years.

Figuring your loss. If your capital losses are more than your capital gains, up to $3,000 of the excess loss is allowed regardless of the amount of your income.

If you have both short-term and long-term items, figure your capital loss as follows:

1) If you had a net short-term capital loss and a net long-term capital gain, your short-term loss is your net short-term capital loss minus your net long-term capital gain.
2) If you had a net long-term capital loss and a net short-term capital gain, subtract your net short-term capital gain from your net long-term capital loss. This is your long-term capital loss.

Yearly limit. The amount of the allowable capital loss that you may deduct in any tax year is the lower of:

1) $3,000 ($1,500 if you are married and file a separate return), or
2) Your capital loss, as shown on line 18 of Schedule D.

Caution: As this publication was being prepared for print, Congress was considering legislation that would restore the provision of prior law limiting the deduction for net capital losses of noncorporate taxpayers to the lesser of:

1) $3,000 ($1,500 in the case of a married individual filing a separate return),
2) The excess of such losses over such gains, or
3) The taxable income for the tax year.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Capital loss carryover. If your capital loss is more than the yearly limit, you may carry over the unused part to the next tax year and treat it as if it occurred in that year. When a loss is carried over, it retains its original character as long term or short term. A short-term loss that is carried over to the next tax year is added to short-term losses that occur in that year. A long-term loss that is carried over to the next tax year is added to long-term losses that occur in that year.

You may carry over a capital loss that is more than the amount of allowable loss to the next year and treat it as if you had incurred it in that year. When you figure the amount of any capital loss carryover in a later tax year, you must take into account any deductions for capital losses allowable in earlier years, whether or not you actually deducted such amounts.

Figuring the carryover. When figuring how much of your capital loss you may carry over as short term and how much as long term, use your short-term losses first, even if you incurred them after a long-term loss. If, after using the short-term loss, you have not reached the limit on the capital loss deduction, use the long-term losses until you reach the limit. Follow these steps to figure the carryover—

1) Figure how much of your total net capital loss is short term and how much is long term. The short-term amount is the loss on line 8 of Schedule D, if any, minus any gain shown on line 17. The long-term amount is the loss on line 17 of Schedule D, if any, minus any gain shown on line 8.
2) Take the amount of your short-term loss (as determined in step (1)) and the total amount of capital loss you were able to deduct this year (line 19) and subtract the smaller amount from the larger amount. If your short-term loss is more than the amount you may deduct this year, the excess is a carryover to your next tax year and is treated as a short-term loss for that year. Your short-term capital loss carryover is figured in Part IV, lines 20 through 24, of Schedule D. If the amount of capital loss you may deduct this year is more than your short-term loss, go to step (3).
3) Complete the following:
    a) First, determine the amount of your long-term loss, as explained in step (1).
    b) Next, subtract either the amount of your short-term loss, if any, as determined in step (1), or the total amount of your deductible capital loss, whichever is smaller, from the total amount of capital loss you were able to deduct this year (line 19).
    c) To determine the amount of your long-term capital loss carryover, subtract the amount you figured in (b) from the amount shown in (a).

You can figure your long-term capital loss carryover in Part IV, lines 25 through 29, of Schedule D.

Example. Bob and Gloria Sampson sold securities in 1988. The sales resulted in a capital loss of $7,000. The Sampsons had no other capital transactions. On their joint 1988 return, the Sampsons can deduct $3,000; the lower of $3,000 or $7,000. The unused part of the loss, $4,000 ($7,000 − $3,000), can be carried over to 1989. If the Sampsons had no taxable income in 1988, the amount of their carryover would still be $4,000. The allowable $3,000 deduction is considered used in 1988, even if they had no taxable income.

If the Sampsons' capital loss had been $2,000, their capital loss deduction would have been $2,000; the lower of $3,000 or $2,000. They would have no carryover to 1989.

Caution: As this publication was being prepared for print, Congress was considering legislation that would restore the provision of prior law that allowed you to carry over to the next tax year the amount of your net capital loss in excess of:

1) $3,000 ($1,500, if you are married and file a separate return), or
2) Your taxable income if your taxable income is less than $3,000 ($1,500 if married filing separately).

Taxable income would be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions for personal exemptions. In other words, the allowable $3,000 deduction would not be considered used if you had no taxable income.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Joint and separate returns. If you are married and filing a separate return, your yearly capital loss deduction is limited to $1,500. Neither you nor your spouse may deduct any part of the other's loss.

If you and your spouse once filed separate returns and are now filing a joint return, you must combine each of your capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separately, any capital loss carryover can be deducted only on the return of the person who actually had the loss.

A decedent's capital loss. Capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. This loss may not be deducted by the decedent's estate or carried over to following years.

Comprehensive Example

Jane Smith is single and in addition to her regular employment, she has income from some stocks and other securities. For the 1988 tax year, she had the following capital gains and losses, which she reports on Schedule D. Her filled-in Schedule D is shown in this chapter.

Capital gains and losses—Schedule D. Jane sold stock in two different companies that she held for short-term. In September she sold 100 shares of Bates Trucking Co. common stock that she had purchased in May. She had an adjusted basis of $650 in the Bates stock and sold it for $900 for a gain of $250. In October she sold 25 shares of Alpha Computing preferred stock that she bought in August. She had an adjusted basis in the Alpha stock of $2,500 and she sold this stock for $2,000 for a loss of $500. These short-term transactions are reported in Part I of Schedule D.

During the year, Jane sold securities she had held for long term in two corporations. In February she sold 60 shares of Car Motor Co. for $2,100. She had inherited the Car stock from her father. Its fair market value at the time of his death was $700, which became her basis. Her gain on the sale, therefore, was $1,400.

Jane had a basis of $3,400 in 50 shares of Weeping Willow Furniture Co. nonconvertible preferred stock that she bought on June 25, 1987. On December 30, 1988 she sold this stock for $4,100. She realized a $700 gain on this sale.

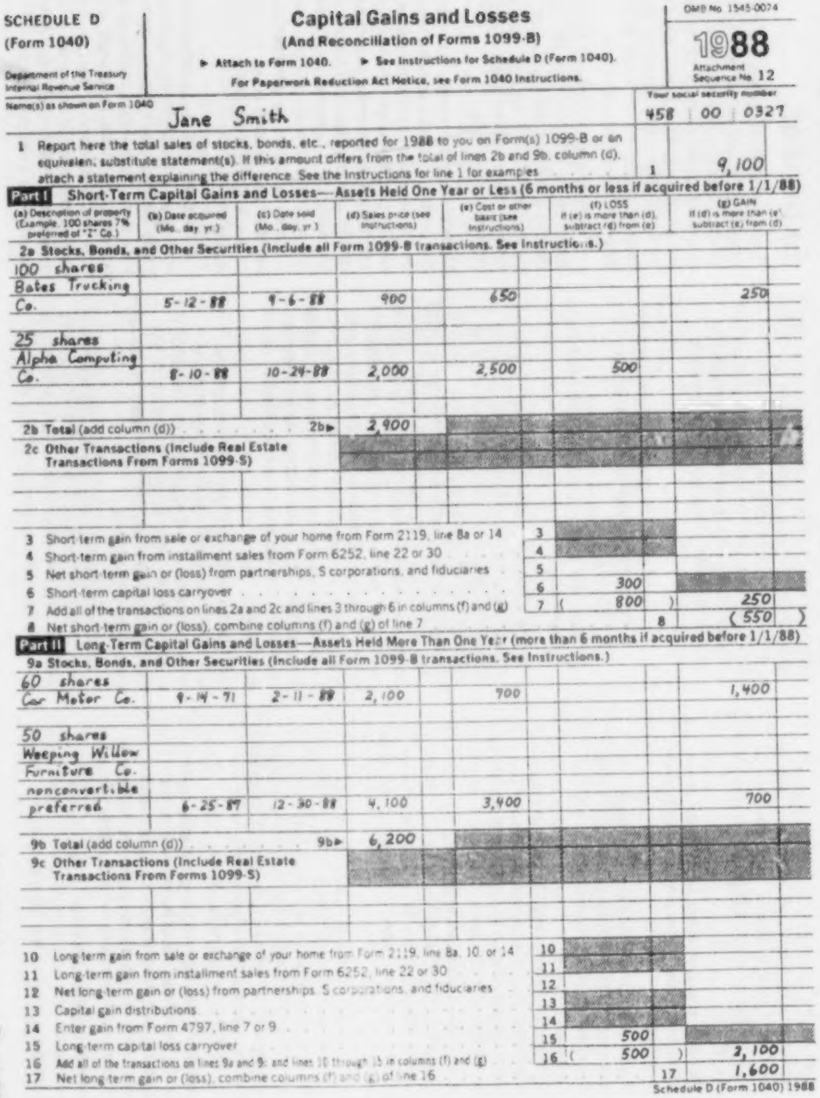
The long-term capital transactions are entered in Part II of Schedule D.

Capital loss carryover—Schedule D. In 1986, Jane had $500 net short-term capital gain and $9,000 net long-term capital loss, resulting in a net long-term loss of $8,500. Of this total, she deducted $3,000 from her income in 1986, requiring $6,000 in capital losses to obtain the $3,000 deduction (prior to 1987, excess long-term capital losses had to be reduced by 50%), leaving a $2,500 carryover to 1987. In 1987, she had a $3,300 short-term capital loss and a $2,000 long-term gain.

For 1987, her remaining $2,500 long-term capital loss carryover from 1986 was merged with her 1987 long-term capital gain of $2,000. The resulting net long-term capital loss of $500, plus the 1987 net short-term capital loss of $3,300, produced a net capital loss of $3,800. Only $3,000 of this was deductible. Because the net short-term capital loss must be used first, $3,000 of the 1987 short-term loss was deducted on Jane's 1987 return. She has a capital loss carryover to 1988 of $800, of which $300 is short-term capital loss, and $500 is long-term capital loss.

Jane kept a copy of her 1987 Form 1040 and Schedule D so she could properly report her loss carryover for the 1988 tax year without refiguring it.

Reconciliation of Forms 1099–B. Jane completes line 1 and Part I and Part II of Schedule D (Form 1040) to reconcile and summarize the amounts reported on Schedule D from the sales of various stocks with the amounts shown on the Forms 1099–B she received from her stockbroker. For 1988, the total of her stock sales is $9,100. Jane reports this amount on line 1 of Schedule D. The total of column (d) on line 2b and line 9b equals the amount shown on line 1 of Schedule D.



SCHEDULE D
(Form 1040)
Department of the Treasury
Internal Revenue Service

Capital Gains and Losses
(And Reconciliation of Forms 1099-B)
▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule D (Form 1040).**
For Paperwork Reduction Act Notice, see Form 1040 Instructions.

OMB No. 1545-0074
1988
Attachment Sequence No. 12

Name(s) as shown on Form 1040: Jane Smith
Your social security number: 458 : 00 : 0327

1 Report here the total sales of stocks, bonds, etc., reported for 1988 to you on Form(s) 1099-B or an equivalent substitute statement(s). If this amount differs from the total of lines 2b and 9b, column (d), attach a statement explaining the difference. See the Instructions for line 1 for examples . . . . . . 1 | 9,100

Part I **Short-Term Capital Gains and Losses—Assets Held One Year or Less (6 months or less if acquired before 1/1/88)**

(a) Description of property (Example, 100 shares 7% preferred of "Z" Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see Instructions)	(e) Cost or other basis (see Instructions)	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
2a Stocks, Bonds, and Other Securities (Include all Form 1099-B transactions. See Instructions.)						
100 shares Bates Trucking Co.	5-12-88	9-6-88	900	650		250
25 shares Alpha Computing Co.	8-10-88	10-24-88	2,000	2,500	500	
2b Total (add column (d)) . . . . . . 2b▶			2,900			
2c Other Transactions (Include Real Estate Transactions From Forms 1099-S)						

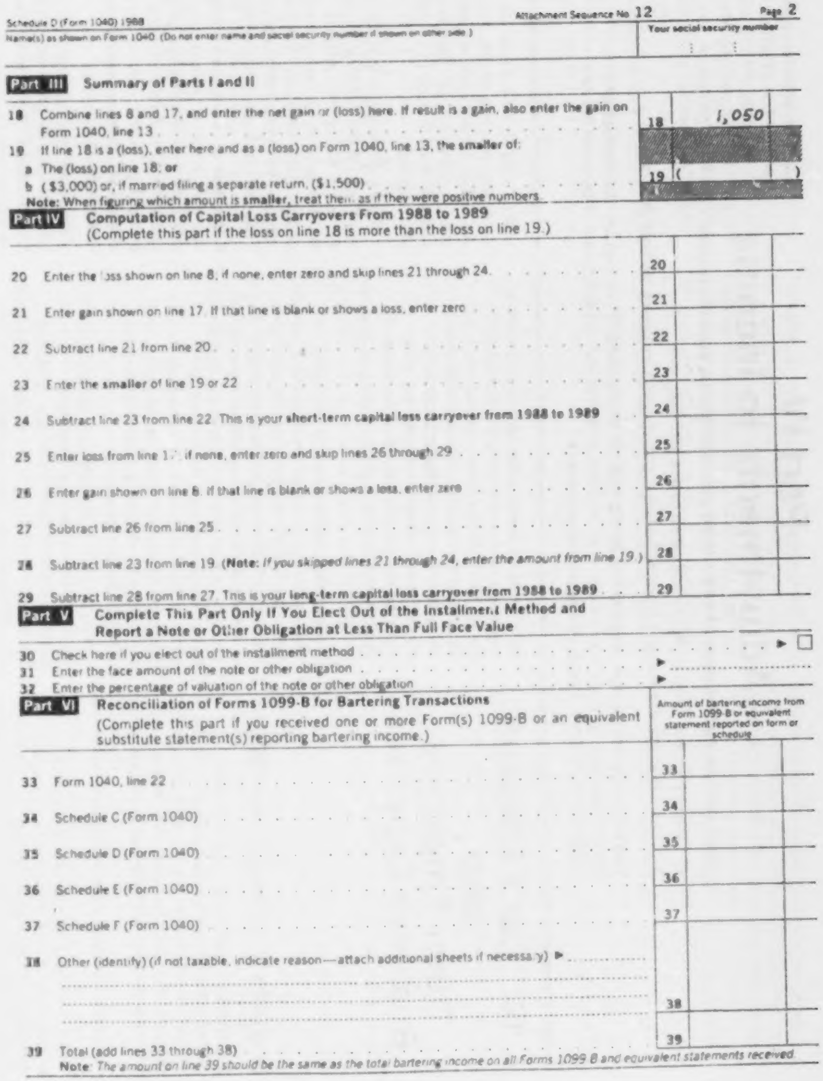
	Line	(f) LOSS	(g) GAIN
3 Short-term gain from sale or exchange of your home from Form 2119, line 8a or 14	3		
4 Short-term gain from installment sales from Form 6252, line 22 or 30	4		
5 Net short-term gain or (loss) from partnerships, S corporations, and fiduciaries	5		
6 Short-term capital loss carryover	6	300	
7 Add all of the transactions on lines 2a and 2c and lines 3 through 6 in columns (f) and (g)	7	(800)	250
8 Net short-term gain or (loss), combine columns (f) and (g) of line 7	8		(550)

Part II **Long-Term Capital Gains and Losses—Assets Held More Than One Year (more than 6 months if acquired before 1/1/88)**

(a) Description of property	(b) Date acquired	(c) Date sold	(d) Sales price	(e) Cost or other basis	(f) LOSS	(g) GAIN
9a Stocks, Bonds, and Other Securities (Include all Form 1099-B transactions. See Instructions.)						
60 shares Car Motor Co.	9-14-71	2-11-88	2,100	700		1,400
50 shares Weeping Willow Furniture Co. nonconvertible preferred	6-25-87	12-30-88	4,100	3,400		700
9b Total (add column (d)) . . . . . . 9b▶			6,200			
9c Other Transactions (Include Real Estate Transactions From Forms 1099-S)						

	Line	(f) LOSS	(g) GAIN
10 Long-term gain from sale or exchange of your home from Form 2119, line 8a, 10, or 14	10		
11 Long-term gain from installment sales from Form 6252, line 22 or 30	11		
12 Net long-term gain or (loss) from partnerships, S corporations, and fiduciaries	12		
13 Capital gain distributions	13		
14 Enter gain from Form 4797, line 7 or 9	14		
15 Long-term capital loss carryover	15	500	
16 Add all of the transactions on lines 9a and 9c and lines 10 through 15 in columns (f) and (g)	16	(500)	2,100
17 Net long-term gain or (loss), combine columns (f) and (g) of line 16	17		1,600

Schedule D (Form 1040) 1988



Schedule D (Form 1040) 1988 Attachment Sequence No. 12 Page 2
Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side.)
Your social security number

Part III **Summary of Parts I and II**

	Line	Amount
18 Combine lines 8 and 17, and enter the net gain or (loss) here. If result is a gain, also enter the gain on Form 1040, line 13	18	1,050
19 If line 18 is a (loss), enter here and as a (loss) on Form 1040, line 13, the **smaller** of: a The (loss) on line 18; or b ($3,000) or, if married filing a separate return, ($1,500) **Note:** When figuring which amount is smaller, treat them as if they were positive numbers.	19	( )

Part IV **Computation of Capital Loss Carryovers From 1988 to 1989**
(Complete this part if the loss on line 18 is more than the loss on line 19.)

	Line	Amount
20 Enter the loss shown on line 8; if none, enter zero and skip lines 21 through 24	20	
21 Enter gain shown on line 17. If that line is blank or shows a loss, enter zero	21	
22 Subtract line 21 from line 20	22	
23 Enter the **smaller** of line 19 or 22	23	
24 Subtract line 23 from line 22. This is your **short-term capital loss carryover from 1988 to 1989**	24	
25 Enter loss from line 17; if none, enter zero and skip lines 26 through 29	25	
26 Enter gain shown on line 8. If that line is blank or shows a loss, enter zero	26	
27 Subtract line 26 from line 25	27	
28 Subtract line 23 from line 19. (**Note:** *If you skipped lines 21 through 24, enter the amount from line 19.*)	28	
29 Subtract line 28 from line 27. This is your **long-term capital loss carryover from 1988 to 1989**	29	

Part V **Complete This Part Only If You Elect Out of the Installment Method and Report a Note or Other Obligation at Less Than Full Face Value**

30 Check here if you elect out of the installment method . . . . . . ▶ ☐
31 Enter the face amount of the note or other obligation . . . . . . ▶
32 Enter the percentage of valuation of the note or other obligation . . . . . . ▶

Part VI **Reconciliation of Forms 1099-B for Bartering Transactions**
(Complete this part if you received one or more Form(s) 1099-B or an equivalent substitute statement(s) reporting bartering income.)

	Line	Amount of bartering income from Form 1099-B or equivalent statement reported on form or schedule
33 Form 1040, line 22	33	
34 Schedule C (Form 1040)	34	
35 Schedule D (Form 1040)	35	
36 Schedule E (Form 1040)	36	
37 Schedule F (Form 1040)	37	
38 Other (identify) (if not taxable, indicate reason—attach additional sheets if necessary) ▶	38	
39 Total (add lines 33 through 38)	39	

Note: *The amount on line 39 should be the same as the total bartering income on all Forms 1099-B and equivalent statements received.*

Part IV

Adjustments to Income

There are two main groups of deductions you can take on your tax return:

1) Those that are used to figure adjusted gross income, and

2) Those that are subtracted from adjusted gross income to figure taxable income.

The chapters in this part discuss the first group of deductions. They include the deductions for alimony you pay, for payments to an individual retirement arrangement (IRA), and for car expenses and other employee business expenses.

19. Car Expenses and Other Employee Business Expenses

Important Change for 1988

Standard mileage rate. The standard mileage rate for 1988 is 24 cents per mile for the first 15,000 miles and 11 cents per mile for all miles over 15,000 and for fully depreciated business vehicles. See *Standard mileage rate.*

This chapter explains business-related expenses for travel, transportation, meals, entertainment, and gifts that you can deduct on your income tax return. It also discusses the reporting and recordkeeping requirements for these expenses.

If you are an employee and have travel, transportation, meal, entertainment, and gift expenses related to your work, you may be able to deduct these expenses on your income tax return.

Outside salespersons must report their expenses in the same manner as all other employees.

If you are not reimbursed for these expenses, you must complete Form 2106, *Employee Business Expenses*, to claim a deduction. You must itemize deductions on Schedule A (Form 1040) to claim these expenses. You must keep records and supporting evidence to prove your expenses, as explained later under *Records.*

If you receive reimbursements or allowances for these expenses, you must include these payments on your income tax return unless you satisfy the rules under *How to Report*, later.

If you include these payments in your income, you must complete Form 2106 to claim a deduction for the expenses. The reimbursed expenses may be claimed as an adjustment to income. Any excess expenses can be claimed only if you itemize your deductions. See *How to Report*, later.

Amounts you spend for your employer for office expenses, local transportation for errands, and other incidental expenses for which you are reimbursed are not deductible. You do not have to report the reimbursement.

Self-employed persons. If you are self-employed as a sole proprietor or independent contractor, deduct the allowable part of your own business travel, entertainment, and meal expenses on line 26 of Part II, Schedule C (Form 1040). Deduct your car expenses for travel and transportation on line 9 of Part II. The amounts you reimburse or allow your employees for these expenses are also reported on line 9 or line 26 of Schedule C. Deduct your business gift expenses on line 29 of Part II.

Independent contractor. If you have reimbursed travel, meal, entertainment, or gift expenses that you incurred on behalf of a client, you must provide adequate accounting of these expenses to your client. If you do not account to your client for these expenses, you must include any reimbursements or allowances in income. You must keep adequate records of these expenses regardless of whether you account to your client for such expense.

If you do not separately account for and seek reimbursement for meals and entertainment in connection with providing services for a client, you are subject to the limit on such expenses. See *Meal and Entertainment Expenses*, later.

Client or customer. If you are a client or customer who, in the course of your business, reimburses or gives an allowance to an independent contractor for travel or gift expenses incurred on your behalf, you are not required to keep records to substantiate the reimbursements. However, you must keep records if:

1) You reimburse the contractor for meal and entertainment expenses incurred on your behalf, and
2) The contractor accounts to you for these expenses.

If the contractor does account to you for meal and entertainment expenses, you must keep records documenting each element of the expense as explained later under *Records* in order to substantiate a deduction on your tax return. If meals and entertainment are accounted for separately, you, but not the contractor, are subject to the limit discussed under *Meal and Entertainment Expenses*, later. You do not, however, have to file an information return to report amounts for which you reimbursed the contractor, as long as he or she fully accounted to you for these expenses.

Corporate officer. If you are a corporate officer who incurred travel, transportation, entertainment, or gift expenses on behalf of a corporation, in order to take a deduction, you must be able to show that they were necessary expenses of the office.

Reimbursement to you by the corporation, or a resolution by the board of directors requiring that you assume such expenses, indicates that you had the expenses because you were an officer. Having such evidence is not conclusive proof that you may or may not deduct these expenses. If the expenses were primarily for your personal benefit, you cannot deduct them and you must include any reimbursement in your income.

If your job requires that you travel and entertain for the corporation, and you are expected to pay the expenses without reimbursement, you are generally able to deduct them. However, there should be a reasonable relationship between your expenses and your compensation.

Expenses of producing income. Ordinarily you can deduct expenses you incurred to produce or collect income, or to manage, conserve, or maintain property held for producing income, only on Schedule A (Form 1040) if you itemize your deductions. See Chapter 30.

However, you can deduct such expenses for property held for producing rents or royalties on Schedule E (Form 1040). See Chapter 10 for information on residential rental property.

Transportation Expenses

Transportation expenses are the ordinary and necessary expenses of getting from one work place to another in the course of your business, profession, or job when you are ***not*** traveling away from home. Expenses for transportation while traveling away from home may be deductible as travel expenses. Travel expenses are discussed later.

Transportation expenses include the cost of travel by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car, but ***not*** the cost of meals and lodging. For information on how to deduct transportation expenses, see *How to Report*, later.

Commuting expenses. You cannot deduct the costs of taking a bus, trolley, subway, taxi, or car between your home and your main or regular place of work. These costs are nondeductible personal expenses. You cannot deduct commuting expenses no matter what the distance is between your home and your regular place of work or if you are employed at different locations on different days within the same city or general area. You cannot deduct commuting expenses even if you do work during the trip.

Example. You had a telephone installed in your car. You sometimes use that telephone to make business calls while commuting to and from work. Sometimes business associates ride with you to and from work and you have a business discussion in the car. These activities ***do not change*** the character of the trip from commuting to business. Your commuting expenses are not deductible.

Hauling tools or instruments in your vehicle while commuting to and from work does not make your commuting costs deductible. However, you can deduct additional costs, such as renting a trailer that is towed by your vehicle, for carrying equipment to and from your job.

Advertising display on car. The use of your car to display material that advertises your business does not convert personal use to business use. If you use this car for commuting or other personal use, your expenses for commuting and other personal use are not deductible.

Trips from a union hall, where you get your work assignments, to your place of work are nondeductible commuting expenses.

Example. You are a banquet waitress who works at several locations in your hometown area. Your union requires you to appear at the union hall to receive your work assignment for the day.

Although you need the union in getting the job, you are employed where you work, not where the union hall is located. Therefore, you cannot deduct the trips from your union hall to your place of work.

Parking fees paid to park your car at your place of work are nondeductible commuting expenses.

Temporary or minor assignment. If you have a temporary or minor assignment beyond the general area of your regular place of work, and return home each evening, you can deduct the expenses of the daily round-trip transportation.

Two places of work. If you work at two places in a day, whether or not for the same employer, you can deduct the expense of getting from one place to the other. However, if for some personal reason you do not go directly from one location to the other, you can deduct only the amount it would have cost you to go directly from the first location to the second. Transportation expenses you have in going between home and a part-time Saturday job are commuting expenses. You cannot deduct them.

Armed forces reservists. If your normal workweek is Monday through Friday and you attend a meeting of an armed forces reserve unit that meets one weekend a month in the general area of your regular place of work and you return to your home on Saturday night, the cost of transportation from your home to the reserve meetings is a commuting expense and you cannot deduct it. If the meetings are held outside the general area, you can deduct the cost of your transportation to attend the meetings. If the reserve meetings are held after work on a normal workday, the preceding paragraph applies.

Car Expenses

If you are required to use your car in your business or work, you may be able to deduct car expenses. The deductible items include the costs of gas, oil, tires, repairs, insurance, depreciation, interest to buy the car, property taxes, licenses, garage rent, parking fees, and tolls. Instead of figuring actual expenses, you may be able to use the standard mileage rate, discussed later.

If you use your car for both business and personal purposes, you must divide your expenses between business and personal use.

Example. You are a sales representative for a clothing firm and drive your car 20,000 miles during the year: 12,000 miles for business and 8,000 miles for personal use. You can only claim 60% (12,000/20,000) of the cost of operating your car as a business expense.

Car placed in service after June 18, 1984. If you place in service after June 18, 1984, a car that has an unloaded gross vehicle weight of 6,000 pounds or less (a gross vehicle weight of 6,000 pounds or less for a truck or van) that you use in your work or business other than transporting people or property for pay, your section 179 deduction and depreciation are limited. You cannot claim any investment credit (generally repealed for cars placed in service after 1985) for a car placed in service after 1985. Also, special rules apply if you use your car 50% or less in your work or business.

Employee use. Generally, you must use a car more than 50% for business or work for the section 179 deduction and depreciation deduction to be allowed. Use of your car in connection with your performance of services as an employee is treated as business use for purposes of determining the amounts allowable to you only if that use is for the convenience of your employer and required as a condition of your employment.

The use of your car must be required for you to perform your assigned duties properly. Whether this use is required depends on all the facts and circumstances. Your employer does not have to require explicitly that you use your car. However, a mere statement by your employer that the use of your car is required as a condition of employment is not sufficient.

Limits. For cars placed in service ***after April 2, 1985, and before 1987,*** the following limits apply. The depreciation or recovery deduction, including the section 179 deduction, could not be more than $3,200 in the year the car was placed in service. The depreciation deduction cannot be more than $4,800 in each recovery year thereafter. These amounts are less if you use your car less than 100% for work or business.

Use Form 4562, *Depreciation and Amortization*, to figure your depreciation.

For cars placed in service ***after 1986,*** the depreciation deduction, including the section 179 deduction, may not be more than $2,560 for the first tax year of the recovery period, $4,100 for the second year, $2,450 for the third year, and $1,475 for each later tax year.

For more discussion of the limits that apply to a car, see Publication 917, *Business Use of a Car.* Publication 917 contains a discussion of section 179 and depreciation deductions for your car.

Depreciation. How you figure your depreciation deduction depends on when you first use your car. The rules for cars you first use before 1987 are different than for cars you first use after 1986.

If you sell a car that you first use before 1987, you cannot deduct depreciation for that car for the year you sell it. You can deduct depreciation for the year you first use your car in business if you bought the car before 1987 and keep it until the end of the year. For cars placed in service after 1986, you get a half-year depreciation in the year placed in service and in the year of disposition.

Your depreciation deduction is limited by the percentage of business use. This is the percentage of your total mileage during your tax year that you drove your car for business. If the percentage of business use changes, your depreciation deduction changes because the basis for figuring depreciation changes.

Example. You bought a car for $9,000 on May 7, 1986, that you used 60% in your business in 1986. You did not take a section 179 deduction.The rate of depreciation for the first year of business use was 25%. You deducted depreciation of $1,350 ($9,000 × 60% ×25%) for 1986. You used this car 70% in your business in 1987. The rate of depreciation for the second year of business use was 38%. You deducted depreciation of $2,394 ($9,000 × 70% × 38%) for 1987. You use the car 80% in your business in 1988. The rate of depreciation for the third year of business use was 37%. You deduct depreciation of $2,664 ($9,000 × 80% × 37%) for 1988.

For more information on depreciation, see Publication 534.

Leasing a car. If you lease a car that you use in your business or work, you can deduct the part of your lease payments that are for the use of the car in your business or work. You cannot deduct any part of the lease payments that are for commuting or other personal use of the car. You must spread any advance payments over the entire lease period. You cannot deduct any payments you make to buy a car even if the payments are called lease payments. If you lease a car after June 18, 1984, you may have to include in income an amount called the "inclusion amount." For more information, see Publication 917.

Standard mileage rate. Instead of figuring actual expenses, you can use the standard mileage rate of 24 cents a mile for the first 15,000 miles of business use each year and 11 cents a mile for each additional mile. If the car is, or is considered to be, fully depreciated, as explained later, the standard mileage rate is 11 cents a mile. You can use this rate instead of actual operating and fixed expenses, including depreciation, in figuring the deductible costs of operating a passenger car, including a van, pickup, or panel truck. You can use the standard mileage rate whether or not you are reimbursed and whether or not the reimbursement is more or less than the amount figured using the standard mileage rate.

Caution: As this publication was being prepared for print, Congress was considering legislation that would allow rural mail carriers working for the U.S. Postal Service to take a higher standard mileage rate. These mail carriers would be allowed to use a rate that is 150% of the standard mileage rate for the first 15,000 miles of business use of a car that is not fully depreciated. However, this computation method cannot be used if the mail carrier claimed depreciation deductions for the car for any tax year after 1987.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

When standard mileage rate can be used. You must choose to use the standard mileage rate in the first year you place your car in service in your business. In later years, you can use the standard mileage rate or actual expenses. If you do not choose the standard mileage rate in the first year, you cannot use it for that car in any year.

If you use the standard mileage rate in the first year of business use, you are considered to have made an election not to use the accelerated cost recovery system (ACRS) or the modified accelerated cost recovery system (MACRS). Since the standard mileage rate allows for depreciation, you also cannot claim the section 179 deduction. If you change to the actual cost method in a later year, but before your car is considered fully depreciated, you have to estimate the useful life of the car and use straight line depreciation.

To use the standard mileage rate you must:

1) Own the car,
2) Not use the car for hire, such as for a taxi, and
3) Not operate a fleet of cars using two or more at the same time.

Fully depreciated. If you use the standard mileage rate, the car is considered fully depreciated after 60,000 miles of business use at the maximum standard mileage rate. For this purpose a car is considered to have been driven no more than 15,000 business miles in any one year, even though the actual business mileage may be more.

Depreciation was allowed in the following years at the rates shown below. The depreciation rate was already included in the standard mileage rate for that year.

Year	Rate per Mile
1988	10.5 cents
1987	10 cents
1986	9 cents
1985	8 cents
1984	8 cents
1983	8 cents
1982	7.5 cents

These rates do not apply, however, for any year in which the actual cost method was used. This depreciation reduces the basis of your car in figuring its adjusted basis when you dispose of it.

If your car is fully depreciated, you may deduct only 11 cents a mile for all miles of business use.

Example. In 1984, you bought a car for use in your business. From 1984 through 1987 you used the standard mileage rate to figure your car expense deduction. You drove your car at least 15,000 business miles each year from 1984 through 1986. In 1987 you drove 20,000 business miles for which you claim a deduction of $3,925 (15,000 miles × 22.5 cents plus 5,000 miles × 11 cents). Your car is considered fully depreciated in 1987 because you have taken deductions for 60,000 miles at the maximum rate. If you use the standard mileage rate for the same car in 1988, you can deduct only 11 cents a mile for all miles of business use. If you change to the actual cost method in 1988, you cannot take a depreciation deduction for that car.

Interest and state and local taxes. You may be able to deduct part of interest on car loans and state and local personal property taxes on motor vehicles in addition to the standard mileage rate. See Chapters 24 and 25 for more information.

Parking fees and tolls you have during business use are deductible in addition to the standard mileage rate.

Spouses with separate businesses. If you and your spouse use a jointly owned car in your separate businesses for a combined total of more than 15,000 miles a year, you can use the standard mileage rate of 24 cents a mile only for the first 15,000 miles. You must use the 11 cents a mile rate for each additional mile of business use whether you file separate returns or a joint return. However, if you and your spouse use separately owned cars in your separate businesses, you do not have to combine the mileage of both cars to use the standard mileage rate. Use the standard mileage rate of 24 cents a mile for the first 15,000 miles of business use of each car and use the 11 cents a mile rate for each additional mile of business use of each car.

If you use more than one car on an alternating basis, the total business mileage of both cars must be combined to figure the 15,000 mile annual limit on the 24-cent mileage rate. However, if one car is, or is considered to be, fully depreciated, do not combine the total business miles of both cars because you may only take 11 cents a mile for the depreciated car.

Example 1. You are a sales representative, and do not receive an allowance from your employer for the use of your car. You own two cars, one you use primarily for business and the other primarily for personal purposes. However, occasionally you use the second car for business. Neither car is fully depreciated this year. If you drive the first car 14,000 business miles during the year and drive the second car 2,000 business miles, you can deduct $3,710 (15,000 miles × 24 cents plus 1,000 miles ×11 cents).

Example 2. If in Example 1, the car you use primarily for business is fully depreciated, you can only take 11 cents a mile for the 14,000 miles that car was driven. You can deduct $2,020 (14,000 miles × 11 cents plus 2,000 miles × 24 cents).

Replacing your car. If you replace your car during the year, and use the standard mileage rate for both the old and new cars, figure your deduction by combining the total business mileage of both cars for the year. However, if the old car is, or is considered to be, fully depreciated, do not combine the total business mileage of both cars. You can only take 11 cents a mile for the old car. See the preceding examples.

If you are reimbursed or receive an allowance for your car expenses, you can use the standard mileage rate to find the cost of operating your car. If you account to your employer and your employer excludes the reimbursed amounts from your income, you can deduct only the cost that is more than your reimbursement or allowance. See *How to Report*, discussed later.

You are reimbursed or receive an allowance if you are paid cash for the use of your car, charge car expenses to your employer, or your employer pays any of the expenses of operating your car.

Example. You drive your car 14,000 miles in your work. You get $900 worth of gas from your employer, who has a gas pump for the business. You decide to use the standard mileage rate to figure your car expenses. You can deduct $2,460 (14,000 miles × 24 cents a mile − $900 for the gas). See *How to Report*, later.

Car expense records. Whether or not you use the standard mileage rate, you must keep records to show when you started using your car for business and the cost or other basis of the car. Your records must also show the business miles you drove your car during the year and the total miles you drove your car during the year. If you use actual expenses, you must keep records of the costs of operating the car, such as car insurance, interest, taxes, licenses, maintenance, repairs, depreciation, gas, and oil. If you lease a car, you must keep records of this cost.

Taxes, interest, and casualty or theft losses. If you use your car as an employee for business purposes, you can claim a deduction for certain expenses. These expenses, which are claimed on Schedule A of Form 1040, are:

Personal property tax on autos (line 7)—See Chapter 24.

A portion of interest (40% of 1988 personal interest paid) on car loans (line 12)—See Chapter 25.

Casualty and theft losses (line 18)—See Chapter 27.

Car pools. You cannot deduct the costs of repairs, gas, and similar items in using your car in a non-profit car pool. Do not include payments from the passengers in your income. These amounts are considered reimbursements of your expenses. However, if you are in a car pool for a profit, you must include these payments in income, but you may also deduct certain operating expenses (using the rules in this chapter).

Fines and collateral for traffic violations are not deductible.

Fringe benefits. Generally, the value of many fringe benefits provided by your employer are taxable and must be included in your income as compensation. If your employer provides you with a car, you have received a fringe benefit. For more information see Publication 917.

Travel Expenses

Travel expenses are your ordinary and necessary expenses while traveling away from home for your business, profession, or job. You can deduct these expenses if you prove them, as explained later under *Records*. However, you cannot deduct expenses that are lavish or extravagant or that are for personal or vacation purposes.

Deductible travel expenses include:

1) Air, rail, and bus transportation,
2) Operating and maintaining your car,
3) Taxi fares or other costs of transportation between the airport or station and your hotel, from one customer to another, or from one place of business to another,
4) Transportation from the place where you eat and sleep to your temporary work assignment,
5) Baggage charges and transportation costs for sample and display material,
6) Meals and lodging when you are away from home on business (see *Meal and Entertainment Expenses*, later, for limitation on deducting meal expenses),
7) Cleaning and laundry expenses,
8) Telephone and telegraph expenses,
9) Public stenographers' fees,
10) Operating and maintaining housetrailers,
11) Tips that are incidental to any of these expenses, and
12) Other similar expenses related to qualifying travel.

Travel expenses do not include expenses for transportation while not traveling away from home and expenses for entertainment. These are discussed elsewhere in this chapter.

You are traveling away from home if your duties require you to be away from the general area of your tax home (see *Tax Home*, later) substantially longer than an ordinary day's work and, during your time off while away, you need to get sleep or rest to meet the demands of your work. This does not mean napping in your car. You do not have to be away from your tax home for a whole day or from dusk to dawn as long as your relief from duty is long enough to get necessary sleep or rest.

Example 1. You are a railroad conductor. You leave your home terminal on a regularly scheduled round-trip run between two cities and return home 16 hours later. During the run you have 6 hours off at your turnaround point where you eat two meals and rent a hotel room to get necessary sleep before starting the return trip. You are considered to be away from home.

Example 2. You are a truck driver. You leave your terminal and return later the same day. You get an hour off at your turnaround point to eat. Because you are not off to get necessary sleep and the brief time off is not an adequate rest period, you are not away from home.

Standard meal allowance. Instead of deducting the actual cost of your meals while you are traveling away from home for business, you can deduct $14 a day if you stay in one general area less than 30 days, or $9 a day if your stay is 30 days or more. You must still prove the actual cost of other travel expenses as well as the time, place, and business purpose of your travel (see *Accounting to Employer* and *Records*, later). Since you are considered to have accounted to your employer, if you received reimbursement, you are not subject to the limit, discussed under *Meal and Entertainment Expenses*, later.

Brief incidental travel away from this general area, such as weekend trips home or for recreation, does not reduce the number of days you are considered to be in a general area.

On the day you begin or end your business travel you are allowed one-fourth of the $14 or $9 rate for each 6–hour quarter of the day during which you are either traveling or away from home. The 6–hour quarters are: midnight to 6 a.m.; 6 a.m. to noon; noon to 6 p.m.; and 6 p.m. to midnight.

Example. You live and work in Los Angeles. Your employer sends you to San Francisco on a temporary assignment. You leave home at 8 a.m. on March 13. Your assignment is completed on April 20. You arrive home at 4 p.m. of that day. You returned home each weekend. You are considered to be in the San Francisco area 32½ days (31 full days and 2 three-quarter days) because the four weekends you returned home do not reduce the number of days you are considered to be in San Francisco. If you do not deduct your actual meal expenses, you may only claim the $9 a day rate for this assignment. If you do not receive reimbursement, you are subject to the limit discussed later under *Meal and Entertainment Expenses*.

However, you may not be able to deduct the full $9 a day for the time you were away from San Francisco on weekends. You may only deduct the lesser of what it cost to travel home or what it would have cost for meals (at $9 a day) and lodging if you had stayed in San Francisco. See *If you go home on your days off*, later.

Reimbursement. If you are reimbursed for your meal expenses while you are traveling away from home, you may use the standard meal allowance if:

1) You are reimbursed a separate amount for meals instead of receiving a combined allowance for both meals and lodging,
2) You reflect any excess reimbursement in your income, as discussed later under *How to Report*,
3) You are not required to provide proof to your employer for the actual amount of your meal expenses, and
4) You are not related to your employer. See *Related to your employer*, later.

If you use the standard meal allowance, you must use it to figure all your deductions for meal expenses during the year, except for reimbursed meal expenses that do not meet the requirements of the preceding paragraph. Use of the standard meal allowance is optional each year.

Educational travel. Expenses for travel that in itself is a form of education are not deductible even if the travel is directly related to your trade or business. An example would be a teacher of American history who takes a tour of Civil War battlegrounds. For more information, see Chapter 29, *Employee's Educational Expenses*.

Investment-related travel. If you took a trip to attend a convention, seminar, or similar meeting, and the expenses were not ordinary and necessary expenses of carrying on your trade or business, you cannot deduct any portion of the cost of the trip. For example, you cannot deduct the cost of investment seminars, stockholders' meetings, or similar type conventions.

New job. You can deduct amounts you spend for travel expenses, including meals (subject to the limit) and lodging, in looking for a new job in your present trade or business. You cannot deduct these expenses if you are looking for work in a new trade or business or in looking for work for the first time. If you are unemployed, and there is a substantial break between the time of your past work and your looking for new work, you cannot deduct these expenses, even if the new work is in the same trade or business as your last previous work. If you are reimbursed or if you received an allowance, see *Interview expenses* in Chapter 6. When you move your home, you may qualify for a moving expense deduction. See Chapter 28.

Tax Home

Generally, your tax home is your main place of business or post of duty, regardless of where you maintain your family home.

Example. You live with your family in Chicago, but work in Milwaukee, where you stay in a hotel and eat in restaurants during the week. You return to Chicago every weekend. You cannot deduct any of your expenses for travel, meals, and lodging in Milwaukee, because that is your tax home and the travel on weekends is not for a business reason.

The entire city or general area in which your business or work is located is your tax home.

Two places of business or work. If you regularly work in two or more areas, your tax home is the general area where your main place of business or work is located.

Main place of business or work. You should use the following factors in determining your main place of business or work:

1) The total time you ordinarily spend working in each area,
2) The degree of your business activity in each area, and
3) The relative amount of your income from each area.

Example. You live in Cincinnati where you have a seasonal job for 8 months and earn $15,000. You work the remaining 4 months in Miami, also at a seasonal job, and earn $4,000. Cincinnati is your main place of work because you spend most of your time there and earn most of your income there.

Living away from your tax home. You may be considered as traveling away from home while working in the same city in which you and your family live.

Example. Your family home is in Pittsburgh, where you work 12 weeks a year. The rest of the time you work for the same employer in Baltimore. In Baltimore you eat in restaurants and sleep in a rooming house. Your salary is the same whether you are in Pittsburgh or Baltimore. Because you spend most of your working time and earn most of your salary in Baltimore, that city is your tax home and you cannot deduct any expenses you have for meals and lodging there. However, when you return to work in Pittsburgh you are away from your tax home even though you stay at your family home. Therefore, you can deduct the cost of your round trip between Baltimore and Pittsburgh, and your part of your family living expenses for meals, subject to the limit, and lodging while you are living and working in Pittsburgh.

Temporary assignment or job. Although you regularly work or carry on your business activities within the city or general area of your home, you may have to work or conduct business at another location. It may not be practical to return home from this other location at the end of each day's work.

If your assignment or job away from your regular place of work is temporary, that is, if its end can be foreseen within a fixed and reasonably short time of usually less than one year, your tax home does not change. You are considered to be away from home for the whole period and your travel expenses are deductible. Generally, if you expect employment to last for less than one year, whether your new work assignment is temporary or indefinite depends on all the facts and circumstances.

An assignment or job expected to last for a year or more is considered ***indefinite*** and presumed not to be temporary. However, under certain circumstances, you may overcome this one-year presumption if an assignment or job is expected to, and does, last one year or more, but less than 2 years. For more information, see Publication 463, *Travel, Entertainment, and Gift Expenses*.

You can deduct the necessary travel expenses in first getting to your temporary assignment or job and in returning to your tax home after the assignment or job ends. Also, you can deduct your reasonable expenses for meals, subject to the limit, and lodging, even for days off, while you are at the temporary location.

If you go home on your days off, you are not away from home while you are in your hometown. You cannot deduct the cost of your meals and lodging there. However, you can deduct your travel expenses, including meals (subject to the limit) and lodging, enroute from the area of your temporary place of work to your hometown and return if they are no more than what it would have cost you for meals and lodging had you stayed at your temporary place of work. If they are more, your deduction is limited to the amount you would have spent had you stayed at your temporary place of work. If you keep your hotel room during your visit home, you can deduct your expenses of returning home only up to the amount you would have spent for meals had you stayed at your temporary place of work.

Indefinite assignment. If your job at the new location is for an indefinite time, that is, if its end cannot be foreseen within a fixed and reasonably short time, that location becomes your new tax home. You cannot deduct your travel, meals, and lodging expenses while there. You must include any amounts you receive from your employer for living expenses in your income, even if they are called travel allowances and you account to your employer for them.

You must determine whether your assignment is temporary or indefinite when you start work. A series of assignments to the same location, all for short periods but which together cover a long period, may be considered an indefinite assignment.

Probationary work period. If you take a job that requires you to move, with the understanding that you will keep the job if your work is satisfactory for a test period, the job is indefinite. You cannot deduct any expenses for meals and lodging during the test period.

Transient workers. If you move from job to job, maintain no fixed home, and are associated with no particular business locality, each place you work becomes your main place of business and your tax home. You cannot deduct your expenses for meals and lodging.

Travel in the United States

If your trip was entirely for business, you can deduct your ordinary and necessary travel expenses. If your trip was primarily personal, you cannot deduct any travel expenses, even if you had some business activity at your destination.

If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a nonbusiness side trip, or had other nonbusiness activities, you can deduct the travel expenses to and from your business destination.

Example. You work in Atlanta and make a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend $450 for the 9 days you are away from home for travel, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days and your total cost would have been $400. You can deduct $400, subject to the limit on meals, for your trip, including the round trip transportation to and from New Orleans.

If the trip was primarily for vacation, the entire cost of the trip is a nondeductible personal expense, except for any expenses you have at your destination that are properly allocable to your business.

A trip can be a vacation even though a promoter advertises that a trip to a resort or on a cruise ship is primarily for business. The scheduling of incidental business activities during a trip, such as viewing video tapes or attending lectures dealing with general subjects, will not make what is intended to be a vacation into a business trip.

If part of the trip is outside the United States, see *Travel Outside the United States,* later. The United States includes the 50 states and the District of Columbia. Travel outside the United States does not include travel from one point in the United States to another point in the United States.

Public transportation. If you travel by public transportation, any place in the United States where that vehicle makes a scheduled stop is a point in the United States.

Private car. Travel by private car in the United States is travel between points in the United States, even though you are on your way to a destination outside the United States.

Private plane. If you travel by private plane, any trip, or part of a trip, for which both your takeoff and landing are in the United States is travel in the United States, even if part of your flight is over a foreign country.

Convention expenses. You can deduct travel expenses for yourself, but not for your family, to attend a convention if you can show that your attendance benefits your own trade or business, as distinguished from the business or work of another. If the convention is for investment, political, social, or other purposes unrelated to your trade or business, you cannot deduct the expenses. Nonbusiness expenses, such as social or sightseeing expenses, are personal expenses and are not deductible. Your appointment or election as a delegate does not, in itself, entitle you to, or deprive you of, the deduction. See *Foreign conventions,* later.

The agenda of the convention need not deal specifically with your official duties or the responsibilities of your position or business. It is enough if the agenda is so related to your active trade or business and its responsibilities that attendance for a business purpose is indicated.

Expenses paid by others. You cannot deduct expenses paid by others or personal expenses you paid for your family members. You must reduce the expenses you pay by reimbursements or allowances received from others.

Expenses for your spouse. If your spouse goes with you on a business trip or to a business convention, you cannot deduct the part of the expenses for travel, meals, and lodging for your spouse, unless you can prove a real business purpose for your spouse's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to warrant a deduction.

Example. You drive to Chicago on business and take your spouse with you. No business purpose is served by your spouse's presence. You pay $115 a day for a double room. A single room is $90 a day. You can deduct the total cost of driving your car to and from Chicago, but only $90 a day for your hotel room. If you use public transportation, you can only deduct your fare.

Travel for the government. You can deduct your travel expenses if you temporarily leave your regular place of business to advise or provide other services to the government but keep your regular business connection. You may have to include your allowances and reimbursements in your income. See *How to Report,* later.

Members of the armed forces of the United States on permanent duty assignments overseas are not traveling away from home and cannot deduct their expenses for meals and lodging, even if they are required to maintain a home in the United States for their families who are not allowed to accompany them. If you are transferred from one permanent duty station to another, see Chapter 28.

Example. A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a home for travel expense purposes aboard ship.

Travel Outside the United States

If you travel outside the United States and the entire time is spent on business activities, you can deduct your travel expenses as if the travel had been entirely in the United States. Travel outside the United States does not include travel from one point in the United States to another point in the United States. If part of the trip is in the United States, see *Travel in the United States,* earlier.

If your travel was primarily for business, but there were some nonbusiness activities, you may not be able to deduct all of your travel costs, including meals and lodging, while going from your home to your business destination and back. You may have to divide the expenses between business and nonbusiness activities.

If the travel was primarily for vacation, or for investment purposes, and some time was spent attending brief professional seminars or a continuing education program, the entire cost of the trip is a nondeductible personal expense, except for registration fees and any other expenses incurred that are directly related to your business.

Example. You are a doctor practicing medicine and are a member of a professional association. The association sponsored a 2-week trip to two foreign countries with three professional seminars in each country. Each seminar was 2 hours long and was held in a different city. You also made an optional side trip to a well-known tourist attraction in each of the countries visited. At the end of the trip you received a Certificate of Continuing Education in Medicine.

You paid the cost of air fare, hotel accommodations, meals, a special escort, transportation to and from hotels, and tips. No part of the cost was for the seminars, which were arranged for you by the sponsoring professional association.

Your participation in the professional seminars did not change what was essentially a vacation into a business trip. Your travel expenses were not related primarily to your business. You had no other expenses that were directly for your business. Therefore, you cannot deduct your trip as an ordinary and necessary business expense.

Travel considered entirely for business. You can deduct your expenses for travel outside the United States using the same rules that apply to travel in the United States if you meet any one of the following conditions.

1) You were an employee, were not related to your employer, were not a managing executive, and were reimbursed or received a travel expense allowance.

   Related to your employer means you are related as described in *A loss on the sale or trade* under *Related Party Transactions* in Chapter 16, except that for this rule, you are related if you own directly or indirectly more than 10% of the stock of your employer corporation.

   A managing executive is an employee who, because of executive authority and responsibility is authorized, not subject to the veto of another, to decide on the need for the business travel.

2) You had no substantial control over arranging the trip. You are not considered to have control merely because you have control over the timing of your trip.

   A self-employed person is generally regarded as having substantial control over arranging business trips.

3) You were outside the United States a week or less, combining business and nonbusiness activities. In counting the days, do not count the day you leave the United States, but count the day you return to the United States.

4) You spent less than 25% of the total time you were outside the United States in nonbusiness activities, even if the trip outside the United States was for more than a week. For this purpose, you count both the day your trip began and the day it ended.

5) You can establish that a personal vacation was not a major consideration, even if you own your business, are related to your employer, are a managing executive, or have substantial control over arranging the trip.

For a more detailed explanation of the rules relating to travel outside the United States, including luxury water travel, see Publication 463.

Foreign conventions. You cannot deduct expenses for attending a convention, seminar, or similar meeting held outside the North American area ***unless*** the meeting is directly related to your trade or business. It also must be as reasonable to hold the meeting outside the North American area as in it.

The North American area includes the United States, its possessions, Canada, Mexico, Jamaica, Barbados, Grenada, and Palau. For foreign conventions, U.S. possessions include Puerto Rico, Guam, American Samoa, and the U.S. Virgin Islands. The North American area may also include certain Central American countries, certain Caribbean countries, and Bermuda. To qualify, certain requirements must be met and the country must be designated by the President as a beneficiary country. For more information, see Publication 463.

Meal and Entertainment Expenses

You may be able to deduct meal and entertainment expenses you have for your trade or business. You can take a deduction if your expenses are directly related to or associated with your trade or business or if certain exceptions apply. You must meet requirements for proving the amount spent and the business nature of the expense.

Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. This covers entertaining guests at night clubs, social, athletic, and sporting clubs, theaters, sporting events, on yachts, or on hunting, fishing, vacation, and similar trips. If you buy a ticket to an entertainment event for a client, the amount subject to the limit, discussed later, cannot be more than the face value of the ticket.

Reciprocal entertaining. Expenses are ***not*** deductible when a group of business acquaintances take turns picking up each other's entertainment checks without regard to whether any business purposes are served.

80% Limit

You can deduct only 80% of your business-related meal and entertainment expenses. This limitation applies to employees or their employers, and to self-employed persons (independent contractors) or their clients, depending on whether the expenses are reimbursed.

The 80% limit applies, for example, to meals incurred while you are traveling away from home (whether eating alone or with others) on business, in entertaining business customers at your place of business or a restaurant, or in attending a business convention or reception, business meeting, or business luncheon at a club. The limit may apply to meals you furnish on your premises to your employees, even if the value of the meals is excluded from the employee's income. There are exceptions, discussed in Publication 463, to the 80% limit.

Taxes and tips relating to a meal or entertainment activity are included in the amount that is subject to the 80% limit. Expenses such as cover charges for admission to a night club, rent paid for a room in which you hold a dinner or cocktail party, or the amount paid for parking at a sports arena, are deductible (if otherwise allowable) subject to the 80% limit. However, the cost of transportation to and from a business meal or entertainment activity that is otherwise allowable is not subject to the 80% limit.

If you pay or incur an expense for goods and services consisting of meals, entertainment, and other services (such as lodging or transportation), you must make an allocation, on a reasonable basis, between the expenses for meals and entertainment and the expenses for the other services. For example, you must make an allocation if a hotel includes one or more meals in its room charge, or you are provided with one per diem amount to cover both your lodging and meal expenses.

You apply the 80% limit after determining the amount that would otherwise qualify for a deduction. You first have to determine the amount of meal and entertainment expenses that would be deductible, under the rules discussed earlier (and in Publication 463). Then, you apply the 80% limit to determine the deductible amount.

Example 1. You spend $100 for a business-related meal. If $40 of that amount is considered lavish and extravagant, then the remaining $60 is subject to the 80% limit. Therefore, you can only deduct $48 for that meal.

Example 2. You purchase two tickets to a concert and give them to a client. You purchased the tickets through a ticket agent. You paid $150 for the two tickets, which had a face value of $60 each. Your deduction cannot be more than $96 (80% of the face value of the tickets).

Application of 80% limit. The 80% limit applies to meal and entertainment expenses that were not fully reimbursed by your employer and are otherwise deductible. Other exceptions are discussed in Publication 463. The limit does not apply only to trade or business expenses. It applies to expenses incurred for the production of income including rental or royalty income. It applies to deductible moving and educational expenses.

Caution: As this publication was being prepared for print, Congress was considering legislation that limits your deduction to 80% for meal expenses that are deductible as moving expenses even if you are reimbursed by your employer. For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

For more information on meal and entertainment expenses, see Publication 463.

Business Gift Expenses

You can deduct the cost of business gifts. However, you cannot deduct more than $25 for business gifts you give, directly or indirectly, to any one individual during your tax year. If a gift to a company is not intended for the eventual personal use or benefit of a particular person or limited class of people, it will not be considered an indirect gift to an individual.

A gift to the spouse or child of a person with whom you are doing business is a gift to that person. However, if the spouse you give the gift to has an independent bona fide business connection with you, the gift generally will not be considered a gift to the other spouse, unless it is intended for that spouse's eventual use or benefit.

If you and your spouse both give gifts, both of you are treated as one taxpayer, even if you have ***separate businesses*** or are ***separately employed*** and even if each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

Exceptions. The following items are not considered gifts subject to the $25 limit:

1) An item that costs $4 or less, on which your name is clearly and permanently imprinted, and which is one of a number of identical items you distribute generally. This includes items such as pens, desk sets, and plastic bags and cases.

2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.

Employee achievement awards. Employee achievement awards are no longer deductible as gifts. For information on how to deduct these awards, see Publication 535, *Business Expenses.*

Incidental costs, such as engraving jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for the $25 rule.

A related cost is considered incidental only if it does not add substantial value to the gift. For example, the cost of gift wrapping is considered an incidental cost, but the purchase of an ornamental basket for packaging fruit is not considered an incidental cost of packaging if the basket has a value that is substantial in relation to the value of the fruit.

Gift or entertainment. Any item that might be considered either entertainment or a gift generally will be considered as entertainment. However, if you give a customer packaged food or beverages intended to be used at a later date, it is a gift.

If you provide tickets to a theater performance or sporting event for a business customer and do not go with the customer to the performance or event, you may treat the tickets either as a gift or as entertainment, whichever is to your advantage. You may change your treatment of the tickets at a later date, but not after the time prescribed for the assessment of income tax. In most instances this is 3 years after the due date of your income tax return. If you go with the customer to the event, you have no choice; the cost of the tickets is entertainment.

How to Report

The following discussions explain how to report your allowable expenses for travel, local transportation, meals, entertainment, education, and gifts.

Employers and self-employed persons must report these expenses on the appropriate form used to report their business income and expenses (such as Schedule C, Form 1040). Employees, including outside salespersons, must complete Form 2106, *Employee Business Expenses,* and attach it to their Form 1040 to claim these expenses.

You need to complete Form 2106 if:

1) You received a reimbursement or allowance and your employer included the amount on your Form W-2 or a Form 1099,
2) You received reimbursement or an allowance that was more or less than your actual expenses that you accounted for to your employer and that was not included on your Form W-2 or on a Form 1099,
3) You received reimbursement or an allowance and did not account to your employer for your expenses, or
4) You received no reimbursement for your employee business expenses.

If your expenses equal your reimbursements and you accounted to your employer, you do not need to complete Form 2106 unless item (1) above applies. See *Accounting to Employer,* later.

Claiming employee business expenses on Form 1040. You claim employee business expenses on your Form 1040 either as an adjustment to income or as an itemized deduction. Follow the instructions given on Form 2106 as to where to report amounts on your Form 1040. See *Completing Form 2106,* later, and the chart in this chapter.

Adjustment to income. If your employer included the reimbursement or other expense allowance you received on your Form W-2 or Form 1099, and did not withhold income tax on that amount, the expenses for which you have been reimbursed are deducted as an adjustment to income to determine your adjusted gross income. Your employer must identify the amount as a reimbursement or allowance on the Form W-2, Form 1099, or in some other manner. You do not have to itemize deductions on Schedule A (Form 1040) to claim these expenses.

Itemized deduction. Expenses for which you have not been reimbursed, or that are in excess of any reimbursement or allowance described earlier under *Adjustment to income,* are deducted as itemized deductions. You can deduct unreimbursed employee business expenses only if you itemize your deductions on Schedule A (Form 1040). This applies to all employees, including outside salespersons.

These unreimbursed employee business expenses are part of your miscellaneous deductions that are subject to a 2% of adjusted gross income limit. The 80% limit on meals and entertainment is applied on Form 2106 before the 2% of adjusted gross income limit is applied on Schedule A (Form 1040). See Chapter 30 for more information on the 2% limit.

Special rules apply to expenses of performing artists and impairment-related work expenses of handicapped employees. See the Form 2106 instructions on how to claim these expenses.

Reimbursement or other expense allowance arrangement. A reimbursement or other expense allowance arrangement includes advances, allowances, and reimbursements from and amounts charged to your employer. It also includes amounts from your employer's agent or a third party for whom you work as an employee of your employer. Allowances include per diem and mileage allowances.

The payments must be made under an express agreement for reimbursement or other expense allowance. Your employer must identify the reimbursement by making a separate payment or by showing the amount separately if it is included in your wages.

Generally, reimbursements are not amounts on which your employer withheld income tax (however, see *No reimbursement,* later).

Caution: Tax law changes effective for **1989 returns** may change how you report your expenses depending on your employer's expense reimbursement policy. For tax year 1989, a reimbursement or other expense allowance arrangement does not include a plan which:

1) Does not require you to adequately account for your expenses to the person providing the reimbursement, or
2) Allows you to keep any excess reimbursement or allowance over the expenses adequately accounted for.

If your employer's plan fits either of these categories your expenses will be treated as unreimbursed and they will be subject to the 2% of adjusted gross income limit on Schedule A.

You are not reimbursed or given an allowance for your expenses if you are paid a salary or commission with the understanding that you will pay your own expenses.

If you do not claim from your employer a reimbursement to which you are entitled, you may not claim a deduction for the expenses to which that reimbursement applies.

Reimbursements for personal expenses received from your employer must be included in your income on line 7 of Form 1040. For example, you must include in income amounts received from your employer for meals if you were not traveling away from home. These expenses are personal and you cannot deduct them.

Allocation of reimbursement. If you receive reimbursement that is less than your employee business expenses that include meal or entertainment expenses, you must allocate your reimbursement. To allocate your reimbursement, determine what part applies to your meal or entertainment expenses based on the facts and circumstances, such as reimbursement for expenses specified by your employer.

If it is unclear from the facts and circumstances whether your meal or entertainment expenses were reimbursed, or what amount was reimbursed for those expenses, allocate your reimbursement in the following manner. Divide your meal and entertainment expenses by your total expenses. Then, multiply the result by your total reimbursement. This is the reimbursement allocated to your meal and entertainment expenses. Deduct this amount from your total reimbursement to determine the reimbursement allocated to your other expenses.

Example. You are an employee and you received $1,500 from your employer during the year for expenses, which was included in Box 10 on Form W-2. You included the $1,500 in your income on line 7 of Form 1040. Your employer did not specify which expenses were reimbursed. Your business expenses for the year were $2,000, broken down as follows:

Car expenses for travel and local transportation	$ 500
Fares for local transportation	120
Travel fares, lodging, and related items while away from home	800
Business meals	180
Other business expenses	400
Total expenses	$2,000

Since your employer did not specify the expenses for which you were paid, you must figure which part of the $1,500 was paid to you for meals.

$$\frac{\text{Meal expense}}{\text{Total business expenses}} \quad \text{X} \quad \text{Total reimbursement}$$

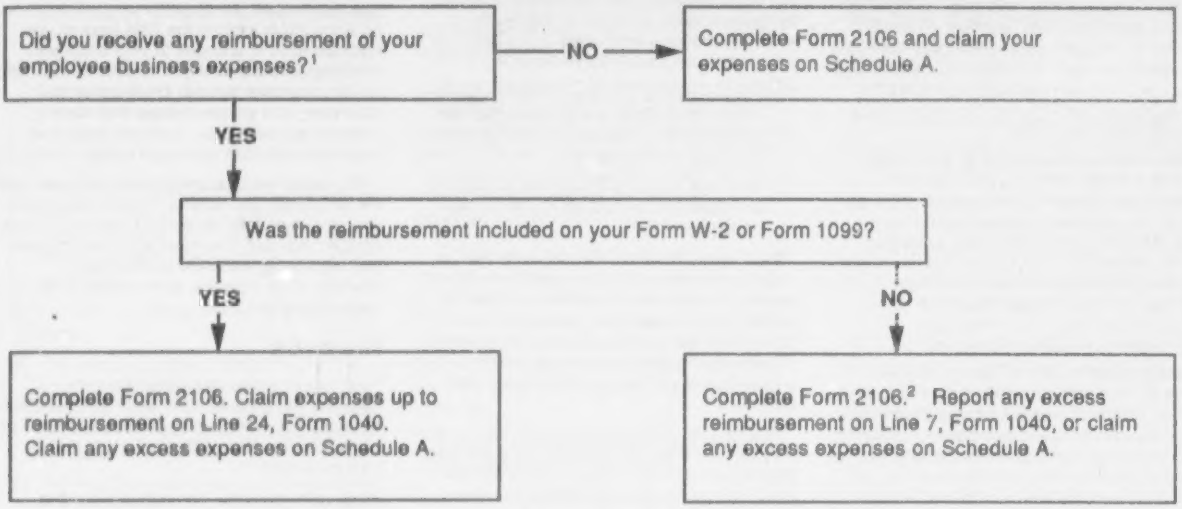
$$\frac{\$\ 180}{\$2,000} \times \$1,500 = \$135$$

Total meals expense	$ 180
Less: Reimbursement for meals	− 135
Unreimbursed meal cost	$ 45
Limitation Percentage	× .80
Deductible meals after limit	$ 36

The rest of the reimbursement of $1,365 ($1,500 − $135) is applied against your other expenses ($1,820), which gives you excess expenses of $455 ($1,820 − $1,365).

After completing Form 2106, you would have $1,500 of reimbursed employee business expenses to deduct as an adjustment to

Reporting Expenses and Reimbursements


Did you receive any reimbursement of your employee business expenses?[1]
NO
Complete Form 2106 and claim your expenses on Schedule A.
YES
Was the reimbursement included on your Form W-2 or Form 1099?
YES
NO
Complete Form 2106. Claim expenses up to reimbursement on Line 24, Form 1040. Claim any excess expenses on Schedule A.
Complete Form 2106.[2] Report any excess reimbursement on Line 7, Form 1040, or claim any excess expenses on Schedule A.

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[1] If you choose not to claim a reimbursement, you cannot claim a deduction for the expense that could have been reimbursed.

[2] If expenses equal reimbursements and you accounted to your employer, you do not need to complete Form 2106, the expenses and the reimbursement are not shown on your return.

income. You would also have $491 ($455 + $36) to deduct as a miscellaneous deduction on Schedule A (Form 1040), if you itemize your deductions. This amount ($491) is added to your other miscellaneous deductions that are subject to the 2% of adjusted gross income limit.

Reimbursement included on Form W-2 or Form 1099. If your employer included your reimbursement or allowance on Form W-2 or Form 1099, you include the amount in your income along with your wages. ***To claim your employee business expenses, you must complete Form 2106.*** Your expenses are claimed as deductions in the following manner.

Expenses equal reimbursement. Your expenses are claimed as an adjustment to income on line 24, Form 1040.

Expenses less than reimbursement. Your expenses are claimed as an adjustment to income on line 24, Form 1040.

Expenses more than reimbursement. The part of the expenses that is equal to your reimbursement is claimed as an adjustment to income on line 24, Form 1040. The part of the expenses that is more than your reimbursement is claimed as a miscellaneous deduction subject to the 2% of adjusted gross income limit on line 20, Schedule A (Form 1040).

Reimbursement not included on Form W-2 or Form 1099. If your employer does not include your reimbursement on Form W-2 or Form 1099, the income and expenses are reported in the following manner.

Expenses equal reimbursement. If your expenses are equal to your reimbursement and you did ***not*** account to your employer, the income and expenses are shown on Form 2106, but are not reported on the Form 1040. If you accounted to your employer, you do not have to show the income or expenses on your return. Form 2106 is not required. See *Accounting to Employer*, later.

Expenses less than reimbursement. If your expenses are less than your reimbursement, you must complete Form 2106. You subtract your expenses from your reimbursement on the Form 2106 and report the excess reimbursement as income on line 7, Form 1040.

Expenses more than reimbursement. If you want to claim expenses that are more than your reimbursement you must complete Form 2106. If you do not want to claim these expenses, see *Expenses equal reimbursement*, earlier in this discussion. To claim excess expenses, subtract your reimbursement from your expenses on Form 2106, and claim the excess expenses as a miscellaneous deduction subject to the 2% of adjusted gross income limit on line 20, Schedule A (Form 1040).

No reimbursement. If you did not receive any reimbursement, you generally must complete Form 2106 and claim the expenses as a miscellaneous deduction subject to the 2% of adjusted gross income limit on line 20, Schedule A (Form 1040). If none of your expenses were reimbursed and you are not claiming any meal, entertainment, travel, or transportation expenses, you do not have to complete Form 2106. Report these expenses on line 20, Schedule A (Form 1040).

If your employer withholds income tax on a payment, it is generally not considered a reimbursement. However, this amount may be considered a reimbursement if you have clear and convincing evidence that shows you had to make an adequate accounting to your employer (see *Accounting to Employer*, later) for your expenses. If you have this evidence, treat the amount as a reimbursement included on Form W-2, as discussed earlier. Attach a statement to your return stating that the amount on line 11, Form 2106 is a reimbursement and that you were required to make an adequate accounting to your employer.

Completing Form 2106

The following is a brief description of how to complete Form 2106. See the *Instructions for Form 2106* for additional information.

Vehicle expenses. If you used a vehicle to perform your job as an employee, you may be able to deduct certain vehicle expenses, as described earlier. Vehicle expenses are generally figured on Part II of Form 2106, and then claimed on line 1, Column A, of Part I of Form 2106.

Employee business expenses other than meals and entertainment. Show your other employee business expenses on lines 2–4, Column A. Do not include expenses for meals and entertainment in these expenses. Line 4 includes expenses such as business gifts, education (tuition and books), office in the home expense, and trade and professional publications. For information on educational expenses that you may be able to deduct, see Chapter 29.

Meal and entertainment expenses. Show the full amount of your expenses for business-related meals and entertainment on line 5, Column B. Include meals while away from your tax home overnight and other business meals. Your meal and entertainment expenses that are subject to the 80% limit are computed in Column B of Form 2106.

Reimbursements included in your Form W–2 or a Form 1099. If your employer included any amount of reimbursement made to you for employee business expenses on your Form W–2 or a Form 1099, enter the reimbursement (except for the part for meals and entertainment) on line 11, Column A, of Form 2106. Show the portion of the reimbursement that is for meals and entertainment on line 11, Column B.

Reimbursements not included on your Form W–2 or a Form 1099. If your employer did not include any amount of reimbursement for your employee business expenses on your W–2 or a Form 1099, write the amount that you received for meals and entertainment on line 7, Column B, and the amount that you received for all other employee business expenses on line 7, Column A. You must allocate reimbursements as accurately as possible.

Reporting on Form 1040. After you have completed your Form 2106, you must follow the directions on that form to report the amounts on the appropriate lines of your Form 1040. You may have to report amounts as income on line 7 of Form 1040; as an adjustment to income on line 24 of Form 1040; or as a miscellaneous deduction on line 20 of Schedule A (Form 1040).

Accounting to Employer

You account to your employer by giving your employer documentary evidence and an account book, diary, or similar record in which you entered each expense at or near the time you made it.

You must account for **all** amounts received from your employer during the tax year as advances, reimbursements, or allowances for travel, entertainment, gifts, or any other expenses. This includes amounts you charge to your employer by credit card or otherwise. You must give your employer the same type of records and supporting information that you would be required to keep to prove the deductions on your return.

Standard mileage rate. If you receive an allowance or reimbursement of not more than the standard mileage rate of 24 cents a mile for business transportation while traveling away from home, and the time, place, and business purpose of the travel are proved, as explained later under *Records*, you will be considered to have made an adequate accounting to your employer. A similar allowance or reimbursement for business transportation while not away from home also will qualify as having been adequately accounted for.

However, if you receive an allowance or reimbursement for business transportation that is more than the standard mileage rate, you will ***not*** be considered to have made an adequate accounting to your employer.

Also, you may receive a separate allowance or reimbursement for parking fees and tolls for business travel and transportation.

Per diem allowance or reimbursement. If, instead of getting reimbursed for living expenses, you get a fixed allowance or reimbursement that is less than $44 a day, or the maximum daily rate authorized to be paid by the federal government in the locality in which the travel is performed, you satisfy the adequate accounting requirements if:

1) Your employer reasonably limits payments of the travel expenses to those that are ordinary and necessary in the conduct of the trade or business, and
2) The time, place, and business purpose of the travel are proved, as explained later under *Records*.

If the Internal Revenue Service finds that an employer's travel allowance practices are not based on reasonably accurate estimates of travel costs, including recognition of cost differences encountered in different localities, the employees will not have accounted to their employer and will be required to prove their expenses.

These rules also apply if you get reimbursed only for your meal expenses or get a per diem allowance that is not more than the standard meal allowance, discussed earlier, because you have no lodging expense during your travel away from home. You would have no lodging expense if your employer furnishes lodging in kind or pays directly for your lodging, or if you stay with friends or relatives or sleep in the cab of your truck.

Living expenses include, but are not limited to, reasonable travel expenses for meals and lodging, laundry, cleaning and pressing of clothing, and fees and tips for services. They do not include transportation, taxi fares, or the cost of telegrams or telephone calls.

Instead of claiming the actual cost of your meals when you are traveling away from home on business, you may be able to claim either $14 or $9 a day for meals if you do not have to provide proof to your employer for the actual amount of your meal expenses. See *Standard meal allowance* under *Travel Expenses*, earlier.

Related to your employer. If you are related to your employer, you cannot take advantage of the fixed per diem allowance or reimbursement rule of having accounted to your employer or the standard meal allowance. You must be prepared to prove any deductions you claim. You may, however, use the standard mileage rate even if you are related to your employer.

To find if you are related to your employer, see *A loss on the sale or trade* under *Related Party Transactions* in Chapter 16. The 50% stock ownership rule in item (2) of that discussion is 10% for this purpose.

If you accounted to your employer for your business expenses that you had solely for your employer's benefit, you need not include on your income tax return your expenses or the amounts you received as a reimbursement or other allowance if the reimbursement equals your expenses, unless your employer includes the reimbursement on your Form W–2 or a Form 1099.

If you are related to your employer, or if your expenses are more than your reimbursement and you deduct the excess expenses, you may be asked by the Internal Revenue Service to supply information about your expense accounts even if you accounted to your employer.

If you did not account to your employer for expenses, complete and attach Form 2106 to your Form 1040. To figure the amount to show on Form 2106, include the total amount you received from or charged to your employer, including amounts charged directly or indirectly to your employer through credit cards or otherwise, and your expenses that were ordinary and necessary business expenses. See *How to Report* discussed earlier.

For expenses charged to your employer, use the actual amount on your Form 2106, even if your employer later received a discount on the amount charged. You must also keep records and supporting evidence to prove each element of an expense, as explained later under *Records*.

Records

You have to prove your deductions for transportation, travel, meal, entertainment, and business gift expenses by adequate records or by sufficient evidence that will support your own statement.

Adequate records. You should keep the proof you need for these items in an account book, diary, statement of expense, or similar record, supported by adequate documentary evidence (such as receipts, cancelled checks, or bills), that together will support each element of an expense.

Duplicate information. You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records and receipts complement each other in an orderly manner. You do not have to record amounts your employer pays directly for any ticket or other travel item. However, if you charge these items to your employer, through a credit card or otherwise, you must make a record of the amounts you spent.

Timely recordkeeping. Record the expense in your account book at or near the time of the expense. Entries made later, when there is a lack of accurate recall, do not comply with these rules.

Expense accounts. An expense account statement you give your employer, client, or customer is considered an adequate record of your expenses. The statement must be a copy of your account book or other record.

Proving expenses. You may deduct transportation expenses, travel expenses, including meals, lodging, and related items while away from home, or expenses for a type of activity generally considered entertainment, amusement, or recreation, or a facility used in connection with such activity, or for any expenses for gifts, only if you can prove certain items.

Deductions are not allowed for approximations or estimates, or for expenses that are lavish or extravagant.

Travel. You must prove:

1) Each separate amount you spent for travel away from home, such as the cost of your transportation or lodging. You may total the daily cost of your breakfast, lunch and dinner, and other incidental elements of such travel if they are listed in reasonable categories, such as meals, gas and oil, and taxi fares.

2) The dates you left and returned home for each trip, and the number of days spent on business away from home.

3) The destination or locality of your travel, described by name of city, town, or similar designation.

4) The business reason for your travel or the business benefit gained or expected to be gained from your travel.

Meals or entertainment. You must prove:

1) The amount of each separate expense for meals or entertainment, except for incidental items, such as taxi fares and telephone calls, which may be totaled on a daily basis.

2) The date the meal or entertainment took place.

3) The name, address or location, and the type of meal or entertainment, such as dinner or theater, if the information is not apparent from the name or designation of the place.

4) The reason for the meal or entertainment, or the business benefit gained or expected to be gained, and the nature of any business discussion or activity that took place.

5) The occupation or other information about the person or persons for whom the meal or entertainment expense is being claimed. Include name, title, or other designation sufficient to establish the business relationship to you.

6) That you or your employee was present at a business meal given for a client.

For more information, see Publication 463.

Gifts. You must prove the:

1) Cost of the gift,

2) Date of the gift,

3) Description of the gift,

4) Reason for giving the gift or any business benefit gained or expected to be gained from giving it, and

5) Occupation or other information about the person receiving the gift, including name, title, or other designation to establish the business relationship to you.

Transportation. You must prove:

1) The amount of each separate expense for a car or any other property used for transportation, such as the cost of buying a car, lease payments, the cost of maintenance and repairs, or other expenses.

2) The mileage for each business or investment use of the car or other means of transportation, and the total miles for the year.

3) The date of the expense or use.

4) The business reason for the expense or use of the car or other means of transportation.

For more information, see Publication 917.

Separating expenses. Each separate payment usually is considered a separate expense. If you entertain a customer or client at dinner and then go to the theater, the dinner expense and the cost of the theater tickets are separate expenses. You must record them separately in your records.

Some items may be totaled in reasonable categories. You may make one daily entry for categories such as taxi fares, telephone calls, gas and oil, and other incidental travel costs. Meals should be in a separate category. You should include tips with the costs of the services you received.

Other items should be totaled. Expenses of a similar nature occurring during the course of a single event will be considered a single expense. Therefore, if during entertainment at a cocktail lounge you pay separately for each serving of refreshments, the total expense for the refreshments is treated as a single expense.

A receipt is ordinarily the best evidence to prove the amount of an expense.

Documentary evidence is required to support all lodging expenses while traveling away from home. It is also required for any other expense of $25 or more, except that if evidence is not readily available for transportation charges, it is not required.

Adequate evidence. Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense. For example, a hotel receipt is enough to support expenses for business travel if it has the name and location of the hotel, the dates you stayed there, and separate amounts for charges such as lodging, meals, and telephone. A restaurant receipt is enough to show an expense for a business meal if it has the name and location of the restaurant, the number of people served, and the date and amount of the expense. If a charge is made for items other than meals and beverages, the receipt must show that this is the case.

Cancelled check. A cancelled check, together with a bill from the payee, ordinarily establishes the cost. However, a cancelled check does not by itself support a business expense without other evidence to show that it was for a business purpose.

Business purpose. A written statement of the business purpose of an expense generally is required. However, the degree of proof varies according to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, a written explanation is not required.

Example. A sales representative who calls on customers on an established sales route does not have to submit a written explanation of the business purpose for traveling that route.

Confidential information relating to an element of a deductible expense, such as the place, business purpose, or business relationship, need not be put in your account book, diary, or other record. However, the information has to be recorded elsewhere at or near the time of the expense and be available to fully prove that element of the expense.

Incomplete records. If you prove the total cost of travel or entertainment but you cannot prove how much it cost for each person, you must divide the cost among your guests if a determination is necessary.

If you do not have adequate records to support an element of an expense, then you must prove the element by:

1) Your own statement, whether written or oral, containing specific information in detail as to the element, and

2) Other supporting evidence sufficient to establish the element.

The Internal Revenue Service may require additional information to clarify or to establish the accuracy or reliability of information contained in your records, statements, testimony, or documentary evidence before a deduction is allowed.

Keeping records and receipts. You must keep proof to support your claim to a deduction as long as your income tax return can be examined. Generally, it will be necessary for you to keep your records for 3 years from the date of filing the income tax return on which you claimed the deduction. A return filed early is considered as filed on the due date.

Employees who give their records and documentation to their employers and are reimbursed for their expenses do not have to keep duplicate copies of this information. However, you may be required to prove your expenses if:

1) You claim deductions for expenses that are more than reimbursements,

2) Your employer does not use adequate accounting procedures to verify expense accounts, or

3) You are related to your employer, as discussed earlier.

Filled-in Form 2106. John Jensen is employed as an outside salesperson by Atlas Garment Co., 1145 Morrison Ave., New York, NY 10123. He uses the standard mileage rate to figure his car expense deduction. He records his total mileage, business mileage, parking fees, and tolls for the year. During the year he drove his car a total of 40,000 miles, of which 32,000 miles were for business. He paid $680 for parking fees and tolls while using his car for business.

John paid $10,000 for lodging, and related items (laundry, cleaning, etc.) while on sales trips away from home. John also paid $2,632 for business meals and $5,870 for entertainment. He received no expense allowance or reimbursement.

John files Form 2106, *Employee Business Expenses*, with his tax return. He must deduct all of his employee business expenses on line 20 of Schedule A (Form 1040). His completed form is shown in this chapter.

Form **2106**

Department of the Treasury
Internal Revenue Service

Employee Business Expenses

▶ See separate instructions.
▶ Attach to Form 1040.

OMB No. 1545-0139
1988
Attachment Sequence No. 54

Your name	Social security number	Occupation in which expenses were incurred
John Jensen	246 00 1357	Salesman

Part I Employee Business Expenses

STEP 1 Enter Your Expenses		Column A Other than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from Part II, line 15 or line 22	1	5,470	
2 Parking fees, tolls, and local transportation, including train, bus, etc.	2	680	
3 Travel expense while away from home, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	10,000	
4 Business expenses not included in lines 1 through 3. Do not include meals and entertainment	4		
5 Meals and entertainment expenses. (See Instructions.)	5		8,502
6 Add lines 1 through 5 and enter the total expenses here	6	16,150	8,502

Note: ***If you were not reimbursed for any expenses in Step 1, skip lines 7–13 and enter the amount from line 6 on line 14.***

STEP 2 Figure Any Excess Reimbursements To Report in Income			
7 Reimbursements for the expenses listed in Step 1 that your employer did **not** report to you on Form W-2 or Form 1099	7		
Note: *If, in both columns, line 6 is more than line 7, skip lines 8 and 9 and go to line 10. You do not have excess reimbursements.*			
8 Subtract line 6 from line 7. If zero or less, enter zero	8		
9 Add the amounts on line 8 of both columns and enter the total here. This is an **excess reimbursement** reportable as income. **Add this amount to any amount shown on Form 1040, line 7** ▶	9		

STEP 3 Figure Fully Deductible Reimbursed Expenses			
10 Subtract line 7 from line 6. If zero or less, enter zero	10		
11 Reimbursements or allowances for the expenses in Step 1 that your employer identified to you, included on Form W-2 or Form 1099, and were not subject to withholding tax **Note:** *The amount entered on line 11 must be reported as income on Form 1040.*	11		
12 Enter the smaller of line 10 or line 11	12		
13 Add the amounts on line 12 of both columns and enter the total here. This is your **fully deductible reimbursed expenses. Also enter the total on Form 1040, line 24** ▶	13		

STEP 4 Figure Unreimbursed Expenses To Deduct on Schedule A (Form 1040)			
14 Subtract line 12 from line 10 **Note:** ***If both columns of line 14 are zero, stop here.***	14	16,150	8,502
15 Enter 20% (.20) of line 14, Column B	15		1,700
16 Subtract line 15 from line 14	16	16,150	6,802
17 Add the amounts on line 16 of both columns and enter the total here. **Also enter the total on Schedule A (Form 1040), line 20.** (Qualified Performing Artists and handicapped employees, see instructions.) ▶	17	22,952	

For Paperwork Reduction Act Notice, see Instructions.

Form 2106 (1988)

Form 2106 (1988) Page 2

Part II Vehicle Expenses (Use either your actual expenses (Section C) or the standard mileage rate (Section B).)

Section A.—General Information		Vehicle 1	Vehicle 2
1 Enter the date vehicle was placed in service	1	1 / 4 / 88	/ /
2 Total mileage vehicle was used during 1988	2	40,000 miles	miles
3 Miles included on line 2 that vehicle was used for business	3	32,000 miles	miles
4 Percent of business use (divide line 3 by line 2)	4	80 %	%
5 Average daily round trip commuting distance	5	10 miles	miles
6 Miles included on line 2 that vehicle was used for commuting	6	2,600 miles	miles
7 Other personal mileage (subtract line 6 plus line 3 from line 2)	7	5,400 miles	miles

8 Do you (or your spouse) have another vehicle available for personal purposes? ☒ Yes ☐ No

9 If your employer provided you with a vehicle, is personal use during off duty hours permitted? ☐ Yes ☐ No ☒ Not applicable

10 Do you have evidence to support your deduction? ☒ Yes ☐ No If "Yes," is the evidence written? ☒ Yes ☐ No

Section B.—Standard Mileage Rate (Do not use this section unless you own the vehicle.)		
11 Enter the smaller of Part II, line 3, or 15,000 miles	11	15,000 miles
12 Subtract line 11 from Part II, line 3	12	17,000 miles
13 Multiply line 11 by 24¢ (.24) (see instructions if vehicle is fully depreciated)	13	3,600
14 Multiply line 12 by 11¢ (.11)	14	1,870
15 Add lines 13 and 14. Enter total here and on Part I, line 1	15	5,470

Section C.—Actual Expenses		Vehicle 1	Vehicle 2
16 Gasoline, oil, repairs, vehicle insurance, etc.	16		
17 Vehicle rentals	17		
18 Value of employer-provided vehicle (applies only if included on Form W-2 at 100% fair rental value, see instructions)	18		
19 Add lines 16 through 18	19		
20 Multiply line 19 by the percentage on Part II, line 4	20		
21 Depreciation from Section D, column (f) (see instructions)	21		
22 Add lines 20 and 21. Enter total here and on Part I, line 1	22		

Section D.—Depreciation of Vehicles (You can only claim depreciation for a vehicle you own. If you use a vehicle 50 percent or less in a trade or business, you cannot claim the Section 179 deduction and you must figure depreciation using the straight line method over 5 years. For other limitations, see instructions.)

	Cost or other basis (a)	Basis for depreciation (Business use only—see instructions) (b)	Method of figuring depreciation (c)	Depreciation deduction (d)	Section 179 expense (e)	Total column (d) + column (e) (enter in Section C, line 21) (f)
Vehicle 1						
Vehicle 2						

20. Individual Retirement Arrangements (IRAs)

An individual retirement arrangement (IRA) is a personal savings plan that lets you set aside money for your retirement. You may deduct your contributions to the plan in whole or in part, depending on your circumstances, and earnings in your IRA are not taxed until they are distributed to you.

Note. Any interest earned from your IRA that is not currently taxed, because you did not withdraw it from your IRA, is not ***tax-exempt*** interest. Do not report this interest on your tax return as ***tax exempt.***

The discussion on IRAs in this chapter provides basic information. For more information, get Publication 590, *Individual Retirement Arrangements (IRAs).*

If you work for yourself, you may also be able to deduct contributions to a self-employed retirement plan (sometimes called a Keogh plan or HR–10 plan). Only self-employed individuals may deduct such contributions. For details, get Publication 560, *Self-Employed Retirement Plans.*

General Information

Anyone who has ***compensation*** can set up an IRA. Compensation includes wages, salaries, commissions, tips, professional fees, bonuses, and any other amounts you receive for providing personal services. It also includes taxable alimony and separate maintenance payments. The amount of your compensation from self-employment income takes into account your Keogh plan deductions.

Compensation does ***not*** include income from property, such as rental income, interest income, or dividend income. Compensation does ***not*** include any amount received as a pension or annuity, or as deferred compensation. Retirement income, including federal civilian and military retirement income, is ***not*** compensation for IRA purposes.

Foreign earned income and other amounts that are excluded from gross income are ***not*** compensation. Therefore, compensation does not include amounts subject to the foreign earned income exclusion or the foreign housing exclusion.

Kinds of IRAs. If you qualify, you may set up either of these two kinds of IRAs:

- Individual retirement accounts (either a trust or a custodial account)
- Individual retirement annuities

If you have an IRA using an ***individual retirement bond***, the IRA qualifies, even though such bonds are no longer available for purchase.

In addition to your own IRA, your employer, labor union, or other employee association may set up a trust account for you, which must be in the form of an individual retirement account. Your employer may also set up a simplified employee pension (SEP), which can be in the form of either an individual retirement account or an individual retirement annuity.

Form of contribution. Contributions must be made by cash, check, or money order. You cannot contribute property. However, you may be able to roll over or transfer certain property from one account to another. See the discussion under *Rollovers* in Publication 590.

Trustee's fees. Trustee's administrative fees which are billed separately and paid by you in connection with your IRA are deductible (to the extent they are ordinary and necessary) as a miscellaneous deduction on Schedule A (Form 1040) and are subject to the 2% adjusted gross income limit (see Chapter 30). These fees are not subject to the $2,000 IRA contribution limit.

Broker's commissions. Broker's commissions which are paid by you in connection with your IRA are subject to the $2,000 IRA contribution limit. They are not deductible as a miscellaneous deduction on Schedule A (Form 1040).

When to set up an IRA. You can set up a new IRA at or before the time you make a contribution.

When to contribute. You must make contributions to your IRA during the tax year or by the due date of your return, ***not*** including extensions. For most people, this will be April 17, 1989.

Year for which contribution is made. If you contribute an amount to your IRA between January 1, 1989, and April 17, 1989, tell the sponsor which year (1988 or 1989) the contribution is for. If you do not tell the sponsor which year it is for, the sponsor may assume the contribution is for 1989, the year the sponsor received it.

When deduction can be claimed. You may choose to take a deduction for your IRA contribution before you actually make the contribution, provided you make it before the due date of your return, ***not*** including extensions.

No contributions after age 70½. You cannot make contributions to your IRA during or after the tax year in which you reach age 70½.

Although you cannot make contributions to your IRA in the year you reach age 70½, you can continue to make contributions to your nonworking spouse's IRA until the year your spouse reaches age 70½. See the discussion under *IRA for a Nonworking Spouse*, later.

Both spouses have compensation. If both you and your spouse have compensation, you each can set up a separate IRA. The contribution for each of you is figured separately and depends on how much each of you earns.

Divorced individuals. All taxable alimony and separate maintenance payments received by an individual under a decree of divorce or

CAN YOU TAKE AN IRA DEDUCTION?

This chart sums up whether you can take a full deduction, a partial deduction, or no deduction, as discussed earlier

If Your AGI Is		If You Are Covered by a Retirement Plan at Work and Your Filing Status is			If You Are Not Covered by a Retirement Plan at Work and Your Filing Status is			
At Least	But Less Than	• **Single**, or • **Head of Household** You Can Take	• **Married Filing Jointly** (even if your spouse is not covered by a plan at work) • **Qualifying Widow(er)** You Can Take	**Married Filing Separately** You Can Take	**Married Filing Jointly** (and your spouse is covered by a plan at work) You Can Take	• **Single**, or • **Head of Household** You Can Take	• **Married Filing Jointly or Separately** (and your spouse is not covered by a plan at work) • **Qualifying Widow(er)** You Can Take	**Married Filing Separately** (even if your spouse is covered by a plan at work) You Can Take
$-0-	$10,000	Full deduction	Full deduction	Partial deduction	Full deduction	Full Deduction	Full Deduction	Full Deduction
$10,000	$25,001	Full deduction	Full deduction	No deduction	Full deduction			
$25,001	$35,000	Partial deduction	Full deduction	No deduction	Full deduction			
$35,000	$40,001	No deduction	Full deduction	No deduction	Full deduction			
$40,001	$50,000	No deduction	Partial deduction	No deduction	Partial deduction			
$50,000 or over		No deduction	No deduction	No deduction	No deduction			

Maximum deduction. You can deduct IRA contributions up to the amount of the deduction (full or partial) you can take, or 100% of your taxable compensation, whichever is less.

$200 floor. The partial deduction has a $[illegible] floor. For example, if your deduction would have been reduced to less than $200 (but not zero), you can deduct IRA contributions up to $200 or 100% of your taxable compensation, whichever is less. If the deduction is completely phased out (reduced to zero), no deduction is allowed.

separate maintenance are treated as compensation for purposes of making IRA contributions. The rules for making contributions to a regular IRA apply. For more information concerning divorced individuals, see Publication 590.

IRA contributions under community property laws. You cannot make IRA contributions based on the earnings of your spouse. The contribution amount is based on your own compensation. However, contributions may be made for a nonworking spouse by a working spouse, as explained later.

Inherited IRAs. If you inherited an IRA from someone who died after December 31, 1983, and you are not the decedent's spouse, you will not be allowed to contribute to that inherited IRA.

Withholding allowances. To figure the number of additional withholding allowances you may claim on your Form W-4, *Employee's Withholding Allowance Certificate*, you may take into account your estimated deductible IRA contributions. For this purpose, however, do not take into account any of your employer's contributions to your SEP-IRA, discussed later, on which tax is not withheld. For more information on withholding, see Chapter 5.

IRA Contributions

The most that can be contributed each year to your IRA is the smaller of the following amounts:

- Your taxable compensation for the year or,
- $2,000.

Full, Partial, or No Deduction?

The deduction you can take for contributions to an IRA depends on:

1) Whether you or your spouse are covered for any part of the year by an employer retirement plan (see *Coverage by an Employer Plan*, later), and if you are covered,
2) How much ***modified*** adjusted gross income (modified AGI), defined later, you have.

Full deduction. If you and your spouse are not covered for any part of the year by an employer retirement plan, you can take a full deduction of up to $2,000, or 100% of compensation, whichever is less.

Partial or no deduction. If you or your spouse are covered for any part of the year by an employer retirement plan, you may be entitled to a full, a partial, or no deduction at all, depending on how much modified AGI you have and your filing status.

If you are married filing a joint return, you can take the full deduction if neither you nor your spouse is covered for any part of the year by an employer retirement plan. If one of you is not covered by a plan but the other is, or if both of you are covered, then your IRA deduction may be reduced or eliminated depending on how much modified AGI both of you have.

If you are married filing a separate return and you are not covered by an employer retirement plan, you can take the full deduction even if your spouse is covered by a plan.

Caution: When this publication went to print, Congress was considering legislation that would treat a married person filing separately as covered by a plan if the spouse was covered by a plan and they lived together at any time during the year.

Marital status. To determine whether you are covered by an employer retirement plan, you are considered married or single based on your filing status on the last day of the tax year. If you were married to two different spouses during the same year, you are considered married for the year to the spouse to whom you were married at the end of the year.

Death of spouse. If your spouse died during the year, and you file a joint return as the surviving spouse, you are entitled to a full, a partial, or no deduction in the same way as if your spouse were still alive. No deduction is allowed, however, for contributions made after the date of death to the deceased spouse's IRA.

Coverage by an Employer Plan

An employer retirement plan is one that an employer sets up for the benefit of the employees.

If you are not certain whether you are covered by your employer's retirement plan, you should ask your employer. Also, the kinds of employer retirement plans to which the IRA rules apply are listed under *Employer Plans* in Publication 590.

Form W-2. The Form W-2, *Wage and Tax Statement*, you receive at the end of the year from your employer will indicate whether or not you are covered. The form will have a check in the "Pension Plan" box if you are covered.

Social security and railroad retirement. Coverage under social security or railroad retirement does not count as coverage under an employer retirement plan for this purpose.

Receiving benefits. If you receive retirement benefits from a previous employer's plan, you are not considered covered by that plan for this purpose. If you are not covered by a current employer's retirement plan, you may be entitled to a full IRA deduction.

Nonvested employees. If your employer sets aside money under a plan during the year for your retirement, you are considered covered by a plan that year. It does not matter if you are not yet vested (given a legal right to the money).

Reservists and volunteer firefighters. Certain members of the reserve units of the Armed Forces and certain volunteer firefighters are not considered covered by local government retirement plans.

Federal judges. New law clarifies that, for IRA purposes, federal judges are covered by an employer retirement plan. Therefore, any deduction for contributions to an IRA may be reduced or eliminated depending on the judges' filing status and modified AGI.

Adjusted Gross Income Limitation

If you are covered by an employer retirement plan, or if you file a joint return with your spouse who is covered by such a plan, you may be entitled to only a partial deduction or no deduction at all, depending on your ***modified*** adjusted gross income (AGI). The deduction begins to decrease when your modified AGI rises above a certain amount and is eliminated altogether when it reaches a higher amount.

Modified adjusted gross income (modified AGI) is defined as follows:

1) If you file Form 1040A—the amount on the page 1 "total income" line, or
2) If you file Form 1040—the amount on the page 1 "adjusted gross income" line figured without any IRA deduction or any foreign earned income exclusion and foreign housing exclusion or deduction.

Caution: If you received ***social security*** benefits, use the special worksheets in the Appendix to Publication 590 to figure your modified AGI.

Deduction phaseout. The deduction is reduced or eliminated entirely depending on your filing status and modified AGI as follows:

If your filing status is:	Your deduction is reduced if your ***modified*** AGI is within phaseout range of:	Your deduction is eliminated if your ***modified*** AGI is:
Single, or Head of household	$25,000–$35,000	$35,000 or more
Married—joint return, or Qualifying widow(er)	$40,000–$50,000	$50,000 or more
Married—separate return	$ -0–$10,000	$10,000 or more

Also, see the chart, *Can You Take An IRA Deduction?*

How To Figure Partial IRA Deduction

If you are covered by your employer plan and your modified AGI is within the phaseout range where the IRA deduction is reduced, you can figure your partial IRA deduction for either Form 1040 or Form 1040A by using the following worksheet. Also, the instructions for these tax forms include an *IRA Worksheet 2*, which you can use instead.

Worksheet for Partial IRA Deduction

(Use only if you are within phaseout range—see *Deduction phaseout*, earlier)

If your filing status is:	And your modified AGI is over:	Enter on line 1 below:
Single, or Head of household	$25,000	$35,000
Married—joint return, or Qualifying widow(er)	$40,000	$50,000
Married—separate return	$-0-	$10,000

Note. If you were married and both you and your spouse worked and you both had IRAs, figure the deduction for each of you separately.

Deductible IRA contributions for an unmarried individual or a working spouse. Complete lines 1 through 8 if contributions were made or will be made to your IRA.

1. Enter amount from above ________
2. Enter your *modified AGI* (combined if married filing jointly) ________

Note. If line 2 is equal to or more than line 1, stop here; your IRA contributions are not deductible; see *Nondeductible Contributions,* later.

3. Subtract line 2 from line 1. If line 3 is $10,000 or more, stop here; you can take a full IRA deduction for contributions of up to $2,000 or 100% of your compensation, whichever is less; see the filled-in IRA Worksheet 1 for Form 1040A (in Chapter 37) or Form 1040 (in Chapter 38), whichever applies ________
4. Multiply line 3 by 20% (.20). If the result is not a multiple of $10, round it to the next highest multiple of $10 (for example, $611.40 is rounded to $620). However, if the result is less than $200, but more than zero, enter $200 ________
5. Enter your compensation (defined earlier). (Do not include your spouse's income, and, if you file Form 1040, do not reduce your compensation by any losses from self-employment.) ________
6. Enter contributions you made to your IRA for 1988, but do not enter more than $2,000 (if you made contributions of more than $2,000 to your IRA, see *Excess Contributions,* later) ________
7. IRA deduction. Compare lines 4, 5, and 6. Enter the smallest amount here. Enter this amount on the Form 1040 or 1040A line for your IRA, whichever applies. (If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8.) ________
8. Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 5 of your Form 8606 (see *Nondeductible Contributions,* later) ________

Deductible IRA contributions for nonworking spouse. Complete lines 9 through 17 **only** if contributions were made to an IRA for your nonworking spouse (discussed later).

9. Enter the smaller of $2,250 or the amount from line 5 ________
10. Add lines 7 and 8. Enter the total (If equal to or more than line 9, stop here; you cannot make IRA contributions for your nonworking spouse. Also, see *Excess Contributions,* later.) ________
11. Subtract line 10 from line 9 ________
12. Enter the smallest of (a) IRA contributions made for 1988 to your nonworking spouse's IRA; (b) $2,000; or (c) the amount on line 11 (if you made contributions of more than $2,000, see *Excess Contributions,* later) ________
13. Multiply line 3 by 22.5% (.225). If the result is not a multiple of $10, round it to the next highest multiple of $10. However, if the result is less than $200, but more than zero, enter $200 ________
14. Enter the amount from line 7 ________
15. Subtract line 14 from line 13. Enter the result but do not enter more than the amount on line 12 ________
16. Compare lines 4, 5, and 15. Enter the smallest amount here and on your Form 1040A or Form 1040. If line 12 is more than line 16 and you want to make a nondeductible contribution for your nonworking spouse, go to line 17 ________

Nondeductible IRA contribution for nonworking spouse

17. Subtract line 16 from line 12. Enter the result here and on your nonworking spouse's Form 8606, line 5 ________

Example. For 1988, Tom and Betty Smith file a joint return on Form 1040. They both work and Tom is covered by a qualified pension plan at work. Tom's salary is $40,000 and Betty's is $6,555. Their combined modified AGI is $46,555. Since it is between $40,000 and $50,000, they can only take a partial deduction (see *Deduction phaseout,* earlier).

Tom contributed $2,000 to his 1988 IRA and Betty contributed $500 to hers. They must use separate worksheets to figure the partial IRA deduction for each of them because both had IRAs.

Tom has nondeductible contributions because his $2,000 IRA contribution for 1988 is more than he can deduct. He decides to leave the nondeductible contributions in his IRA rather than withdraw them. Betty does not have nondeductible contributions because her $500 IRA contribution for 1988 is less than the $690 amount she could have deducted. (See line 4 of her worksheet, later).

Using the *Worksheet for Partial IRA Deduction,* Tom figures that his 1988 deductible IRA contributions are $690 and that his nondeductible contributions for 1988 are $1,310 as follows:

1. Married—joint return	$50,000
2. Enter your combined modified AGI	46,555
3. Subtract line 2 from line 1	$ 3,445
4. Multiply line 3 by 20% (.20). $689 is rounded to the next highest multiple of $10	$ 690
5. Enter your compensation. (Tom's compensation)	$40,000
6. Enter IRA contributions you made for 1988, but do not enter more than $2,000	$ 2,000
7. IRA deduction. Compare lines 4, 5, and 6. Enter the smallest amount here. Enter this amount on the Form 1040 or the Form 1040A line for your IRA, whichever applies. (If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8.)	$ 690
8. Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on your Form 8606, line 5	$ 1,310

Note. Nondeductible contributions are discussed later.

Betty can make deductible IRA contributions of up to $690 (the same as Tom's deductible IRA contributions since they filed a joint return), but her deduction is limited to $500 (her total IRA contributions for 1988) as follows:

1. Married—joint return	$50,000
2. Enter your combined modified AGI	46,555
3. Subtract line 2 from line 1	$ 3,445
4. Multiply line 3 by 20% (.20). $689 is rounded to the next highest multiple of $10	$ 690
5. Enter your compensation. (Betty's compensation)	$ 6,555
6. Enter IRA contributions you made for 1988, but do not enter more than $2,000	$ 500
7. IRA deduction. Compare lines 4, 5, and 6. Enter the smallest amount here. Enter this amount on the Form 1040 or the Form 1040A line for your IRA, whichever applies. (If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8.)	$ 500

The IRA deductions of $690 and $500 on the joint return for Tom and Betty total $1,190. Betty's unused IRA deduction limit of $190 ($690 – $500) cannot be transferred to Tom to increase his deduction. Tom's deductible IRA contribution for 1988 is still limited to $690.

IRA for a Nonworking Spouse

You can make contributions to an IRA for your nonworking spouse as well as to your own IRA. This arrangement is sometimes called a spousal IRA. To qualify:

1) You must be married at the end of the tax year,
2) You and your spouse must file a joint return,
3) You must have compensation that must be included in your income for the year,
4) Your spouse must receive no compensation during the year or, by claiming a spousal deduction, must choose to be treated as receiving no compensation, and
5) Your spouse must be under age 70½ at the end of the year.

Deductible Contributions for Nonworking Spouse

The deduction phaseout rules discussed earlier that reduce or eliminate your IRA deduction also apply to a spousal IRA. If you have a spousal IRA, are covered by an employer retirement plan, and your modified AGI is within the phaseout range, you can only take a partial deduction.

Example. The following lines 9 through 17 of the *Worksheet for Partial IRA Deduction* show how to figure the deductible IRA contributions for the Smiths using the same facts in the earlier *Example,* except that Tom contributed $250 to a spousal IRA because Betty had no compensation for the year.

9. Enter the smaller of $2,250 or the amount from line 5	$2,250
10. Add lines 7 and 8. Enter total	2,000
11. Subtract line 10 from line 9	$250
12. IRA contributions made for nonworking spouse's IRA, but not more than $2,000 or the amount on line 11, whichever is smaller	$250

13. Multiply line 3 by 22.5% (.225). $775 is rounded to the next highest multiple of $10	$780
14. Enter line 7	690
15. Subtract line 14 from line 13. Enter the result but do not enter more than the amount on line 12	$90
16. Compare lines 4, 5, and 15. Enter the smallest amount here and on the Form 1040 or Form 1040A line for your spouse's IRA, whichever applies. If you want to make a nondeductible contribution for your nonworking spouse, go to line 17	90
Nondeductible IRA contribution for nonworking spouse	
17. Subtract line 16 from line 12. Enter the result here and on your nonworking spouse's Form 8606, line 5	$160

The IRA deductions of $690 and $90 on the joint return for Tom and Betty total $780. In this case, the full spousal IRA deduction of $2,250 (limited to $2,000 for either spouse's IRA) has been reduced by the IRA deduction phaseout rules to $780 (limited to $690 for either spouse's IRA).

Nondeductible Contributions

Although your deduction for IRA contributions may be reduced or eliminated, you can still make contributions of up to $2,000 ($2,250 for a spousal IRA) or 100% of compensation, whichever is less. You just may not be able to deduct all or part of the contributions. In any case, none of the earnings on any contributions (deductible or nondeductible) will be taxed until they are distributed.

Withdrawal of contributions. If you made IRA contributions for 1988, you can withdraw them tax-free (except for any earnings on them) by April 17, 1989 (or a later date, if you have an extension to file your return). You can do this if:

- You did not take a deduction for the contributions, and
- You also withdraw any interest or other income earned on the contributions (you must report this earned income on your 1988 return; also this income may be subject to a tax on early withdrawals—see *Premature Distributions*, later).

Example. Sonny Jones is single. He is covered by a retirement plan at work. In 1988, Sonny's salary is $52,312. He made a $2,000 IRA contribution for 1988. Because Sonny's income is above $35,000, he cannot deduct his $2,000 IRA contribution on his 1988 tax return. However, he may choose to either:

1) withdraw the IRA contribution for 1988 as explained above, or
2) designate this contribution as a ***nondeductible*** contribution by reporting it on his tax return, explained next.

Reporting nondeductible contributions. You do not have to designate a contribution as deductible or nondeductible until you file your tax return. You must use Form 8606, *Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions*, for this purpose. If you do not report nondeductible contributions to an IRA, all of your IRA contributions will be treated as deductible. In that case, the full amount of withdrawals from the IRA will be taxed unless you can show, with satisfactory evidence, that nondeductible contributions were made.

In the first example, under *How to Figure Partial IRA Deduction*, earlier, Tom made nondeductible contributions of $1,310 (shown on the worksheet) for 1988 and decided not to withdraw them. He must report these contributions on Form 8606.

File Form 8606 only if:

- You made IRA contributions for 1988 that you choose to be nondeductible, or
- At the end of 1987, your IRA included nondeductible contributions and during 1988 you received from it a distribution (withdrawal) other than one you rolled over tax-free to another IRA by the end of 1988. See *Rollovers*, later.

Caution: When this publication went to print, Congress was considering legislation that would subject taxpayers to a $50 penalty for each failure to file Form 8606, unless they can show that the failure was due to reasonable cause. For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Penalty for overstatement. If you overstate the amount of nondeductible contributions on your Form 8606 for any tax year, you must pay a penalty of $100 for each overstatement, unless it was due to reasonable cause.

Excess Contributions

Generally, an excess contribution is the amount contributed to your IRA that is more than the smaller of the following amounts:

- Your taxable compensation for the year, or
- $2,000.

Example. Barry earns $18,000 in 1988. If he contributes $2,500 to his IRA for 1988, he will have made an excess contribution of $500 ($2,500 minus $2,000).

Tax on excess contributions. You must pay a 6% excise tax each year on excess amounts that remain in your IRA. The excess is taxed for the year the excess contribution is made and for each year after that until you correct it. The tax cannot be more than 6% of the value of your IRA as of the end of your tax year.

Excess contributions you withdraw by the date your return is due. You will not have to pay the 6% excise tax if you withdraw the excess amount (and interest or other income earned on it) by the due date of your return, including extensions. You do not include in your gross income an excess contribution that you withdraw from your IRA before your tax return is due if you did not take a deduction for that excess amount on your return.

However, you must include in your gross income any interest or other income earned on the excess contributions (whether deductible or nondeductible contributions). Report it on your return for the year the excess contribution was made. This withdrawal of interest or other income is subject to an additional 10% tax on early withdrawals, discussed later.

Excess contributions you withdraw after your return is due. If the total contributions for the year were $2,250 or less, you may withdraw any excess contribution after the due date for filing your return, including extensions, and not include the amount withdrawn in your income. This applies only to the part of the excess contribution that you did not deduct on your return. It is not necessary to withdraw the interest or other income earned on the excess. You will have to pay the 6% tax on the excess amount for each year the excess contribution was in the IRA.

Rollovers

A rollover is a tax-free distribution of cash or other assets from one retirement program to another. The rollover contribution must be made within 60 days of receiving the distribution from your IRA or your employer's plan, unless the period is extended. The 60-day period may be extended if the amount that was distributed to you is a frozen deposit. For more information on frozen deposits, get Publication 590.

There are two kinds of rollover contributions to an IRA. In one, you roll over amounts from one IRA to another. With the other, you roll over amounts from a qualified employer benefit plan, such as a qualified pension plan, to an IRA. You cannot deduct a rollover contribution on your tax return. If you keep any cash or other assets that you can roll over, that part is fully taxable. See *Taxable distributions* under *How to File*, later.

If you roll over a distribution from your pension plan to an IRA, you must tell the trustee or issuer of the IRA in writing that that contribution to the IRA is to be treated as a rollover.

Waiting period between rollover distributions. A rollover distribution from an IRA may be made to you only once a year. The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over (reinvest it) into another IRA. This rule applies separately to each IRA you own.

Inherited IRA. If an individual, other than the decedent's spouse, inherits an IRA from someone who died after December 31, 1983, the inherited IRA may not be rolled over into, or receive a rollover from, another IRA.

For further information on rollovers, get Publication 590.

Distributions

Any money or property you receive from your IRA account or annuity is a distribution. In general, you include distributions in your gross income as ordinary income in the year you receive them. Exceptions to the general rule are tax-free rollovers and withdrawals of:

- contributions by the due date (including extensions) for filing your tax return for the year the contributions are made, and
- excess contributions.

Required distributions. You cannot keep funds in your IRA indefinitely. After you reach 70½, you must begin receiving distributions from your IRA. If a minimum amount is not distributed to you by the *required beginning date*, you may have to pay an excise tax on *excess accumulations* in your IRA.

Required beginning date. You must begin receiving distributions from your IRA by April 1 of the year following the year in which you reach age 70½. If the distributions are to be made over a period of years, the distributions made by April 1 are treated as made for the previous year in which the IRA owner reached age 70 ½. Required distributions for later years must be made by December 31 of each year.

For more information, including how to figure the minimum amount to distribute each year, get Publication 590.

Excess accumulations. If the actual distribution from your IRA during the year is less than the minimum amount that should be distributed, the difference is an excess accumulation. You may have to pay a 50% excise tax on the excess amount for that year and for any year the excess remains in the account.

To figure the amount that should be distributed, get Publication 590. To report any excise tax due on excess accumulations, use Form 5329, *Return for Individual Retirement Arrangement and Qualified Retirement Plans Taxes.*

If you have a good reason for having an excess accumulation in your IRA, you may request that the tax be excused.

For more information on excess accumulations, get Publication 590.

Withholding. Income tax is withheld from the taxable part of distributions you receive from an IRA unless you choose not to have tax withheld.

Withholding from IRAs paid outside the United States. If your home address is in a foreign country and you receive IRA payments, you cannot choose exemption from withholding on your payments. To choose exemption from withholding on payments you receive from your IRA, you must be a U.S. citizen or resident and give the payer of the IRA a home address in the United States. Otherwise, the payer must withhold tax. Tax withholding is discussed in Chapter 5.

Premature Distributions (Early Withdrawals)

Premature distributions are amounts you withdraw from your IRA before you are either 59½ or disabled.

You must include premature distributions in your gross income and, because they are premature, there will be an additional 10% tax on them.

Exceptions. The 10% tax will not apply to the following distributions:

- Portions of any distributions treated as a return of nondeductible contributions,
- Distributions made after the person's death,
- Distributions made because the person becomes disabled, and
- Distributions that are a part of a series of substantially equal payments over the life or life expectancy of the person or the person and his or her beneficiary.

Rollovers. The tax on premature distributions does not apply to amounts that are rolled over tax free.

Simplified Employee Pension (SEP)

A simplified employee pension (SEP), sometimes called a SEP-IRA, is a plan that permits your employer to contribute each year up to 15% of your compensation or $30,000, whichever is less, to your SEP-IRA. This percentage and dollar limit includes amounts your employer takes out of your salary and contributes to the plan under a ***salary reduction arrangement***, discussed later. In addition, you may make deductible or nondeductible contributions of up to $2,000 to your SEP-IRAs independent of your employer's contributions. See the rules on IRAs, (discussed earlier).

If you are a ***highly compensated employee***, the $30,000 limit is reduced if, in a SEP integrated with social security, your employer chooses to treat FICA or self-employment taxes as SEP contributions.

A ***highly compensated employee*** is an employee who during the year or preceding year:

1) Owns more than 5% of the capital or profits interest in the employer (if not a corporation); or more than 5% of the outstanding stock or more than 5% of the total voting power of all stock of the employer corporation;
2) Received annual compensation from the employer of more than $75,000;
3) Received annual compensation from the employer of more than $50,000 and was a member of the top-paid group of employees during the year; or
4) Is an officer whose annual compensation exceeds 150% of the limit on the annual additions under a defined contribution plan.

Salary reduction arrangement. A SEP may include a salary reduction arrangement. Under the arrangement, you may elect to have the employer make contributions (up to $7,313) to the SEP-IRA out of your salary.

Employer's SEP contributions excluded from employee's wages on Form W-2. Employer's SEP contributions are excluded from employee's income. Therefore, these contributions are not included in your Form W-2 wages. However, if you choose to have your employer make SEP contributions out of your salary under a salary reduction agreement, these contributions are included in Form W-2 wages for social security (FICA) tax purposes only.

Since the employer's contributions to the SEP-IRA are not included in your income for income tax purposes, you cannot take a deduction for the employer's contributions.

Even if your employer makes contributions to your SEP-IRA, you can deduct the contributions you make to another IRA. The phaseout rules apply to any amounts ***you*** contribute.

If you are self-employed (a sole proprietor or partner) with a SEP-IRA or a Keogh (HR-10) plan, take your deduction for your SEP-IRA contributions on line 27, Form 1040.

Excess contributions. If your employer contributes too much to your SEP-IRA, resulting in an excess contribution, you will not have to pay the 6% excise tax on it if you withdraw this excess amount (and interest or other income earned on it) from your SEP-IRA before the due date for filing your tax return, including extensions. However, you may have to pay an additional 10% tax on the early withdrawal of the interest or other income earned on the excess contribution. See *Excess Contributions,* earlier.

For more information on a SEP-IRA, get Publication 590.

Prohibited Transactions

Generally, a prohibited transaction is any improper use of your IRA. Some examples of prohibited transactions with an IRA are:

- Borrowing money from it,
- Selling property to it,
- Receiving unreasonable compensation for managing it, or
- Using the IRA as collateral for a loan.

Effect on an IRA account or annuity. If you engage in a prohibited transaction at any time during the year with your IRA, all or part of your IRA account or annuity will not be treated as an IRA as of the first day of the year.

Once this happens, you must include the fair market value of all or part of the IRA's assets in your gross income for that year. The fair market value is the price at which the IRA assets would change hands between a willing buyer and a willing seller, when neither has any need to buy or sell, and both have reasonable knowledge of the relevant facts.

You must use the fair market value of the assets as of the first day of the year you engaged in the prohibited transaction. You may also have to pay the 10% tax on premature distributions, discussed earlier.

Investment in collectibles. If your IRA (or your individually-directed account under your employer's plan) invests in collectibles, the amount invested after 1981 is considered distributed to you in the year invested. This means that the tax advantages of IRAs have been eliminated for this kind of investment. You may have to pay the 10% tax on premature distributions.

Collectibles include art works, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, and certain other tangible personal property.

Exception. IRAs are permitted to invest in certain gold and silver coins issued in the United States and acquired after December 31, 1986.

For more information on prohibited transactions, see Publication 590.

How to File

Form 1040 and Form 1040A. For Form 1040, use line 25a to deduct contributions to your IRA and, if you file a joint return, use line 25b to deduct contributions to your spouse's IRA. For Form 1040A, use line 12a to deduct contributions to your IRA and, if you file a joint return, use line 12b to deduct contributions to your spouse's IRA. Either form may be used if contributions are made by you directly to your IRA or to your nonworking spouse's IRA. For all other transactions connected with an IRA, you must use Form 1040. Form 1040EZ does not provide for IRA deductions.

Form 1099-R. You will receive Form 1099-R, *Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.,* or similar statement, if you receive a total distribution from your IRA. IRA distributions are shown in Boxes 1 and 2 of Form 1099-R. Box 7 contains a number that tells you what type of distribution you received from your IRA.

Form W-2P. You will receive Form W-2P, *Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments,* if you receive an IRA payment that is not a total distribution. Attach Form W-2P to your tax return.

Taxable distributions. Report fully taxable distributions, including taxable premature distributions, on line 16b, Form 1040 (no entry is required on line 16a). If only part of the distribution is taxable, enter the total amount on line 16a, and the taxable part on line 16b.

Rollover. Report any rollover from a qualified plan into an IRA or other qualified plan on line 17a, Form 1040. If the total distribution was rolled over, enter zero on line 17b. Otherwise, enter the taxable part of the distribution on line 17b.

Form 5329. Use Form 5329, *Return for Individual Retirement Arrangement and Qualified Retirement Plans Taxes*, to report the tax on excess contributions, premature distributions, excess distributions, and excess accumulations. Complete Form 5329 and attach it to your Form 1040 only if you owe one or more of the IRA (and qualified retirement plans) penalty taxes. Enter the total amount of IRA tax due on line 52, Form 1040.

If you do not have to file a Form 1040 but you do have to pay one of the IRA taxes mentioned earlier, file the completed Form 5329 with IRS at the time and place you would have filed your Form 1040. Include a check or money order payable to IRS for the tax you owe, as shown on Form 5329. Write your social security number, tax form number, and tax year on your check or money order.

If you do not owe any IRA (or qualified retirement plan) penalty taxes, you do not need to file Form 5329.

Form 5498. You should receive Form 5498, *Individual Retirement Arrangement Information*, or similar statement, from plan sponsors, showing all the contributions made to your IRA for 1988.

For more information on IRAs, see Publication 590.

21. Alimony

This chapter discusses payments made under divorce or separation instruments executed after 1984 and the changes made by the 1986 Tax Reform Act.

There have not been any changes to the rules for payments made under instruments executed before 1985 and not modified to have the new rules apply. Generally, you continue to treat these alimony or separate maintenance payments in the same way as in prior years. These rules are discussed in Publication 504, *Tax Information for Divorced or Separated Individuals*.

Alimony is an amount paid to a spouse or former spouse under a divorce or separation instrument.

Alimony is deductible. You may deduct alimony or separate maintenance payments that you are required to make to your spouse or former spouse. You may not deduct payments for child support. To find out whether you may claim your child as a dependent, see Chapter 3. Property settlements are not alimony. You do not have to itemize deductions to claim your alimony payments. You deduct alimony from gross income to find your adjusted gross income. You enter the alimony on line 29 of Form 1040. You may not use Form 1040EZ or Form 1040A to claim this deduction.

If you deduct alimony or separate maintenance payments, you must include on your return for the year payment is made your spouse's or former spouse's last name, if different than yours, and social security number. Enter this name and number in the space provided on line 29 of Form 1040. Your spouse or former spouse must give you the social security number. If you do not include this social security number on your return, you may have to pay a $50 penalty. Your spouse or former spouse may have to pay a $50 penalty for failure to give you the social security number.

Alimony is income. Alimony or separate maintenance payments that you receive are taxable income to you. Report this income on line 11 of Form 1040. You may not use Form 1040EZ or Form 1040A to report your alimony income.

If you receive alimony, which is not subject to withholding, you may have to make estimated tax payments. See Chapter 5 for more information.

Divorce or separation instrument. The term "divorce or separation instrument" means:

1) A decree of divorce or separate maintenance or a written instrument incident to that decree,
2) A written separation agreement, or
3) A decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse, including a temporary decree, an interlocutory (not final) decree, and a decree of alimony pendente lite (while awaiting action on the final decree or agreement).

Instruments Executed After 1984

To qualify as alimony, the following rules apply to payments under divorce or separation instruments executed after 1984. These rules also apply to payments made under a divorce or separation instrument executed before 1985, but changed after 1984 to specify that these rules will apply. However, if a decree of divorce or separate maintenance executed after 1984 includes without change the terms of the alimony or separate maintenance payments under an instrument executed before 1985, that decree will be treated as executed before 1985.

A change in the amount of the payment, period of payment, of the addition or deletion of any contingencies or conditions is a change in the terms. For examples, see Publication 504.

Alimony and separate maintenance payments. A payment received by, or on behalf of, a spouse or former spouse under a divorce or separation instrument is alimony if the spouses do not file a joint return and all of the following requirements are met.

1) The payment is in cash.
2) The parties do not designate that the payment is not alimony.
3) If the parties are separated under a decree of divorce or separate maintenance, the parties are not members of the same household when the payment is made.
4) There is no liability to make any payment (in cash or property) after the death of the recipient spouse.
5) The payment is not treated as child support.
6) The minimum term rule is met for instruments executed in 1985 or 1986.

Most of these requirements are discussed below.

Payment must be in cash. Only cash payments, including checks and money orders, qualify as alimony or separate maintenance payments. Transfers of services or property, including a debt instrument of a third party or an annuity contract, execution of a debt instrument, or the use of property do not qualify as alimony or separate maintenance payments.

Payments to a third party. Assuming all other requirements are met, a cash payment to a third party under the terms of the divorce or separation instrument will qualify as a cash payment that is received on behalf of a spouse or former spouse. For example, cash payments of rent, mortgage, tax, or tuition liabilities of your spouse or former spouse made under the terms of the divorce or separation instrument will qualify as alimony or separate maintenance payments.

Also, cash payments made to a third party at the written request of your spouse or former spouse will qualify as alimony or separate maintenance payments. This written request must state that both parties intend the payments to be treated as alimony or separate maintenance payments. You must receive the written request from your spouse or former spouse before you file your return for the year you made the payments.

Insurance premiums. Premiums you pay for life insurance on your life under a divorce or separation instrument qualify as payments on behalf of your spouse or former spouse to the extent that your spouse or former spouse is the owner of the policy.

Payments designated as not alimony. You and your spouse or former spouse may designate, by including a provision in a divorce or separation instrument, that payments otherwise qualifying as alimony or separate maintenance payments are not deductible by you and are excludible from income by your spouse or former spouse. If both of you have executed a written separation agreement, any writing signed by both of you that designates otherwise qualifying alimony or separate maintenance payments as nondeductible and excludible and that refers to the written separation agreement will be treated as a written separation agreement, and thus a divorce or separation instrument, for this purpose. If you are subject to temporary support orders, the designation of otherwise qualifying alimony or separation payments as nondeductible and excludible must be made in the original or a subsequent temporary support order.

The spouse or former spouse who is excluding the payments from income must attach a copy of the instrument containing the designation of payments as not alimony or separate maintenance payments to his or her return for each year in which the designation applies.

Parties cannot be members of the same household. Generally, if you make a payment at the time you and your spouse or former spouse are members of the same household, that payment cannot qualify as an alimony or separate maintenance payment if you are separated under a decree of divorce or separate maintenance. For this purpose, a dwelling formerly shared by both of you is not considered two separate households even if you physically separate yourselves in the dwelling. You will not be treated as members of the same household if one of you is preparing to leave the household of the other, and leaves not more than 1 month after the date the payment is made.

If you are not separated under a decree of divorce or separate maintenance, a payment under a written separation agreement or a support decree or other court order may qualify as an alimony or separate maintenance payment even if both of you are members of the same household at the time the payment is made.

Liability for payments after death of recipient spouse. Even though all other requirements are met, if you must continue to make payments for any period after the death of your spouse or former spouse, none of the payments made before or after the death qualify as alimony or separate maintenance payments.

The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse or former spouse if, for example, the liability for continued payments would end under state law.

Example. You are to pay your former spouse $10,000 in cash each year for 10 years under a divorce decree which states that the payments will end on the death of your former spouse. In addition, under the decree, you are to pay your former spouse or your former spouse's estate $20,000 in cash each year for 10 years. Because the $20,000 annual payments will not end on the death of your former spouse, these payments will not qualify as alimony or separate maintenance payments. However, the separate $10,000 annual payments will qualify as alimony or separate maintenance payments.

Substitute payments. If you are required to make any payments in cash or property after the death of your spouse or former spouse as a substitute for the continuation of otherwise qualifying payments, none of these otherwise qualifying payments will qualify as alimony or separate maintenance payments. To the extent that one or more payments are to begin to be made, increase in amount, or become accelerated in time as a result of the death of your spouse or former spouse, the payments may be treated as a substitute for the continuation of otherwise qualifying payments.

The determination of whether or not the payments are a substitute for the continuation of payments that would otherwise qualify as alimony or separate maintenance payments, and of the amount of the otherwise qualifying alimony or separate maintenance payments for which the payments are a substitute, will depend on all of the facts and circumstances.

Example 1. Under the terms of a divorce decree, you are obligated to make annual alimony payments of $30,000 to your former spouse ending on the earlier of the expiration of 6 years or the death of your former spouse. Your former spouse has custody of your minor children. The decree provides that at the death of your former spouse, if there are minor children remaining, you will be obligated to make annual payments of $10,000 to a trust, the income and corpus (principal amount in the trust) of which are to be used for the benefit of the children until the youngest child attains the age of majority.

These facts indicate that your liability to make annual $10,000 payments in trust for the benefit of your minor children on the death of your former spouse is a substitute for $10,000 of the $30,000 annual payments. Therefore, $10,000 of each of the $30,000 annual payments will not qualify as alimony or separate maintenance payments.

Example 2. Under the terms of a divorce decree, you are obligated to make annual alimony payments of $30,000 to your former spouse, ending on the earlier of the expiration of 15 years or the death of your former spouse. The divorce decree provides that if your former spouse dies before the expiration of the 15–year period, you will pay to your former spouse's estate the difference between the total amount that you would have paid had your former spouse survived, minus the amount actually paid.

For example, if your former spouse dies at the end of the tenth year in which payments are made, you will pay to your former spouse's estate $150,000 ($450,000 – $300,000). These facts indicate that your liability to make a lump-sum payment to your former spouse's estate on the death of your former spouse is a substitute for the full amount of each of the annual $30,000 payments to your former spouse. Therefore, none of the annual $30,000 payments to your former spouse will qualify as alimony or separate maintenance payments. The result would be the same if the lump sum payable at your former spouse's death were discounted by an appropriate interest factor to account for the prepayment.

Child support. If you make a fixed payment or a payment treated as fixed for the support of your child under a divorce or separation instrument, the payment does not qualify as an alimony or separate maintenance payment. You may not deduct child support payments that you make. You do not include in income child support payments that you receive.

A payment is fixed as a child support payment if the divorce or separation instrument specifically designates an amount of money or a part of the payment as a child support payment. The designated amount or part of the payment may vary from time to time. ***A payment will be treated as fixed*** as a child support payment if the payment is reduced either on the happening of a contingency relating to your child, or at a time that can clearly be associated with the contingency. A payment may be treated as fixed as a child support payment even if other separate payments are specifically designated as child support payments.

Contingency relating to your child. A contingency relates to your child if the contingency depends on any event relating to that child. It does not matter whether the event is certain or likely to occur.

Events that relate to your child include:

- Attaining a specified age or income level,
- Dying,
- Marrying,
- Leaving school,
- Leaving the household, or
- Gaining employment.

There are ***two situations*** in which payments that would otherwise qualify as alimony or separate maintenance payments will be presumed to be reduced at a time clearly associated with the happening of a contingency relating to your child. In all other situations, reductions in payments will not be treated as clearly associated with the happening of a contingency relating to your child. The first situation is where the payments are to be reduced not more than 6 months before or after the date the child is to attain the age of 18, 21, or local age of majority. The second situation is where the payments are to be reduced on two or more occasions that occur not more than 1 year before or after a different child attains a certain age between the ages of 18 and 24. This certain age must be the same for each child, but need not be a whole number of years.

Either you or the Internal Revenue Service may rebut the presumption in these two situations. This is done by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to your children. The presumption in the first situation will be rebutted conclusively if the reduction is a complete cessation of alimony or separate maintenance payments during the third or sixth post-separation year, or on the expiration of a 36- or 72-month period. (Post-separation years are discussed later.) The presumption may also be rebutted in other circumstances, for example, by showing that alimony payments are to be made for a period customarily provided in the local jurisdiction, such as a period equal to one-half the duration of the marriage.

Minimum term rule. This rule applies only to payments made under instruments executed in 1985 or 1986. For any part of the annual payment that is more than $10,000 to qualify as an alimony or separate maintenance payment, you must meet the minimum term rule. This rule requires that alimony or separate maintenance payments be called for, at a minimum, during the first 6 post-separation years. (See *Post-separation years,* later under *Recapture Rule.*)

To determine whether alimony or separate maintenance payments are to be made in any year, the possible termination of the payments by a contingency (other than by the passage of time) which has not yet occurred is ignored, unless the contingency may cause part of the payment to be treated as a child support payment.

Example. Under a divorce decree, you are to make alimony payments to your former spouse of $20,000 in each of the 5 calendar years 1986 through 1990. You are to make no payment in 1991.

Under the minimum term rule, only $10,000 will qualify as an alimony payment in each of the calendar years 1986 through 1990. If the divorce decree also required you to make a $1 payment in 1991, the minimum term rule would be satisfied and $20,000 would be treated as an alimony payment in each of the calendar years 1986 through 1990.

Recapture Rule

The recapture rule was enacted to limit the extent to which large payments made over a relatively short period (front-loaded payments) can qualify as alimony or separate maintenance. The recapture rule changes the tax treatment of past payments by requiring you to include previously deducted alimony or separate maintenance payments in income. It also allows the recipient spouse, who previously included the alimony in income, to deduct the recaptured amount.

This recapture rule generally applies to payments made under divorce or separation instruments entered into after 1986. It also applies to payments made under instruments entered into before 1987 if the instrument has been modified after 1986 to specify that the 1986 Tax Reform Act changes are to apply. For the recapture rule that applies to instruments entered into before 1987 and not modified to have the 1986 Act changes apply, see *Instruments executed in 1985 or 1986,* later.

The recapture rule does not apply if payments are not more than $15,000 in any of the first 2 post-separation years (defined later). Also, payments under a temporary decree or court order requiring you to make payments for support or maintenance are disregarded entirely in applying the recapture rule. See *Exceptions to the recapture rule* for additional circumstances not subject to the recapture rule, later.

When to recapture. Under the recapture rule, payments made in the second post-separation year will be recaptured if the payments exceed the payments made in the third post-separation year by more than $15,000. Payments made in the first post-separation year will be recaptured if those payments exceed the average of the alimony or separate maintenance payments made in the second post-separation year (not including the payments recaptured as described above) and the third post-separation year by more than $15,000. The excess amounts for both the first and second post-separation years will be recaptured only in the third post-separation year.

Post-separation years. The first post-separation year is the first calendar year in which you pay your spouse or former spouse alimony or separate maintenance payments. The second and third post-separation years are the next two calendar years whether or not you make payments during those years.

The first post-separation year does not have to start with the year you separate or divorce, or with the year in which payments under the divorce or separation instrument are made, if no payments during that year qualify as alimony or separate maintenance payments. If you have been making payments under a decree of divorce or separate maintenance or a written separation agreement, a modification of the instrument or the substitution of a new instrument, such as the substitution of a divorce decree for a written separation agreement, will not create additional post-separation years.

However, if you have been making payments under a support decree or other court order, the first post-separation year does not begin until the first calendar year in which alimony or separate maintenance payments are made under a decree of divorce or separate maintenance or a written separation agreement.

For the ***minimum term rule,*** discussed earlier, the 6 post-separation years are the 6 consecutive calendar years beginning with the first post-separation year.

How to report. Include the recapture amount in income by showing it on line 11 (Alimony received) of Form 1040, and by crossing out "received" and writing "recapture". You must indicate on that line the last name and social security number of your former spouse.

Your former spouse is allowed a deduction for the recapture amount in figuring adjusted gross income for the third post-separation year. Your former spouse deducts the excess amount in figuring adjusted gross income by showing the excess amount on line 29 (Alimony paid) of Form 1040, and by crossing out "paid" and writing "recapture." Your last name and social security number must be shown on that line.

Figuring the amount to be recaptured. First, you add the payments you made in the third post-separation year to the $15,000 floor. Then you subtract that result from the alimony payments you made in the second year. You must recapture any remaining amount.

Next you add the average alimony or separate maintenance payments you made in the second post-separation year (not including the payments recaptured as described above) and the third post-separation year to the $15,000 floor. Then you subtract that result from the alimony payments you made in the first year. You must recapture the remaining amount.

The total of both steps is recaptured at the end of the third post-separation year. Publication 504 has a worksheet to help you figure the amount of alimony you have to recapture.

Example. Al and Jane were divorced on February 3, 1987. Jane pays Al the following amounts of alimony under the terms of her divorce decree. Jane's filled-in *Worksheet for Recapture of Alimony,* is shown later.

Year	Amount
1987 (1st post-separation year)	$60,000
1988 (2nd post-separation year)	40,000
1989 (3rd post-separation year)	20,000

Jane figures her amount to be recaptured as shown below:

Year 2 Calculation

Alimony paid in the second year		$40,000
Alimony paid in the third year	$20,000	
Plus: $15,000 Floor	$15,000	
Total		35,000
Second year payments recaptured in 1989		$ 5,000

The amount allowed as alimony for the second year is $35,000 ($40,000 − $5,000). This is the amount of second year payments used in figuring the recapture for the first post-separation year.

Year 1 Calculation

Alimony paid in the first year		$60,000
Average alimony payments made in the second and third year [($35,000 + $20,000) ÷ 2]	$27,500	
Plus: $15,000 Floor	15,000	
Total		42,500
First year payments recaptured in 1989		$17,500

Jane will show $22,500 ($5,000 + $17,500) as income on her 1989 Form 1040. Al will show the same amount as a deduction on his 1989 Form 1040.

Instruments executed in 1985 or 1986. Although most of the alimony rules apply to payments made under all divorce or separation instruments entered into after 1984, the recapture rule is different for payments under some pre-1987 instruments. The following rules apply to payments made under instruments entered into in 1985 or 1986 (or pre-1985 instruments previously modified to include the tax changes made by the Tax Reform Act of 1984) and not modified after 1986 to specify that the 1986 Tax Reform Act changes are to apply.

Recapture rule. If the amount of alimony or separate maintenance payments you paid in any of the first 3 post-separation years (the computation year), falls short of the amount of alimony or separate maintenance payments you paid in any prior post-separation year by more than $10,000, you must figure the amount to be recaptured for the computation year.

The amount to be recaptured for any computation year is the sum of excess amounts determined for each prior post-separation year. The excess amount determined for a prior post-separation year is the excess of the amount of alimony or separate maintenance payments made during the prior post-separation year over the amount of the alimony or separate maintenance payments paid during the computation year plus $10,000.

For this calculation, the amount of alimony or separate maintenance payments made during any post-separation year preceding the computation year is reduced by any excess amount previously determined for that preceding year.

Report the amounts on your return in the same manner as explained under *How to report,* earlier.

Example. You were divorced in 1986. Your divorce decree has not been modified to specify that the 1986 Tax Reform Act changes are to apply. You make alimony payments to your former spouse of $25,000 in 1986 and $12,000 in 1987.

The excess amount for 1986 that is recaptured in 1987 is $3,000 [$25,000 − ($12,000 + $10,000)]. For later computation years, the amount considered paid in 1986 is $22,000.

If you make alimony payments to your former spouse of $1,000 in 1988, the excess amount that is recaptured in 1988 will be $12,000. This is the sum of an $11,000 excess amount for 1986 [$22,000 − ($1,000 + $10,000)] and a $1,000 excess amount for 1987 [$12,000 − ($1,000 + $10,000)].

Exceptions to the recapture rule. In addition to the $15,000 exempt annual payment ($10,000 for payments under instruments executed in 1985 or 1986), there are three exceptions to the recapture rule.

1) Payments received under temporary support orders before divorce or separation.
2) Payments made under a continuing liability over the period of the post-separation years to pay a fixed part of your income from a business or property or from compensation for employment or self-employment.
3) Payments in any post-separation year that end because of your death or the death of your spouse or former spouse or the remarriage of your former spouse at any time before the end of the third post-separation year.

If alimony or separate maintenance payments you made decline or stop during any of the first 3 post-separation years for any other reason, then you may be subject to the recapture rule. These other reasons include:

- A failure to make timely payments,
- A modification of the divorce or separation instrument,
- A reduction in the support needs of your former spouse, or
- A reduction in your ability to provide support.

Example. Under a divorce decree, you are to make cash payments to your former spouse of $30,000 in each of the calendar years 1987 through 1991. You make cash payments of $30,000 in 1987 and $14,000 in 1988, in which year your former spouse remarries and your alimony payments stop. You pay nothing in 1989. The recapture rule does not apply.

Worksheet for Recapture of Alimony

(For instruments executed after 1986)

Note: Do not enter less than zero on any line. Year refers to post-separation year as described in this publication.

1.	Alimony paid in **2nd year**		$40,000	
2.	Alimony paid in **3rd year**	$20,000		
3.	Floor	15,000		
4.	Add lines 2 and 3		35,000	
5.	Subtract line 4 from line 1			$5,000
6.	Alimony paid in **1st year**		60,000	
7.	Adjusted alimony paid in **2nd year** (line 1 less line 5)	35,000		
8.	Alimony paid in **3rd year**	20,000		
9.	Add lines 7 and 8	55,000		
10.	Divide line 9 by 2	27,500		
11.	Floor	15,000		
12.	Add lines 10 and 11		42,500	
13.	Subtract line 12 from line 6			17,500
14.	Recaptured alimony Add lines 5 and 13			22,500

Part V
Standard Deduction and Itemized Deductions

After you have figured your adjusted gross income, you are ready to subtract the deductions used to figure taxable income. You may subtract either the standard deduction or itemized deductions. For the most part, itemized deductions are deductions for various kinds of personal expenses that are grouped together and listed on Schedule A (Form 1040). They include deductions for medical and dental expenses, taxes and interest you pay, charitable contributions, nonbusiness casualty and theft losses, and various other miscellaneous expenses. The chapters in this part discuss the standard deduction and each itemized deduction.

22. Standard Deduction

Important Changes for 1988

Standard deduction. The standard deduction, which is for taxpayers who do not itemize deductions on Schedule A of Form 1040, is higher in 1988 than it was in 1987. The amount generally depends upon your filing status.

Standard deduction for age and for blindness. If you are age 65 or older or blind in 1988, your standard deduction is higher than for taxpayers under 65 and not blind. However, your standard deduction remains the same as for 1987 if you qualified for the higher amounts last year.

The Standard Deduction

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions. The ***standard deduction*** is a dollar amount which reduces the amount of income on which you are taxed. It is a benefit which is intended to reduce the need for many taxpayers to itemize actual deductions, such as medical expenses, contributions, or taxes, on Schedule A of Form 1040. The benefit is higher for taxpayers who are 65 or older or blind. If you have a choice, you should use the method which gives you the lower tax.

The amount of the standard deduction depends on your filing status and whether you are 65 or older or blind.

Persons not eligible for the standard deduction. Your standard deduction is **zero** and you are encouraged to itemize your deductions if:

1) You are married and filing a separate return and your spouse itemizes deductions.
2) You are filing a tax return with a short tax year.
3) You are a dual status alien during the year. You are considered a dual status alien if you were both a nonresident alien and a resident alien during the year.

Note. If you file a joint return with your spouse who was a U.S. citizen or resident at the end of 1988 and you both agree to be taxed on your combined worldwide income, you may take the standard deduction that applies to you.

Dependents may have a limited standard deduction. If you can be claimed as a dependent on another person's return (such as your parents' return), your standard deduction may be limited. See *Standard Deduction for Dependents*, later in this section.

You benefit from the standard deduction if your standard deduction is more than the total of your allowable itemized deductions.

The following table shows standard deduction amounts for most taxpayers for 1988:

Filing Status	Amount
Single	$ 3,000
Married Filing Jointly	5,000
Married Filing Separately	2,500
Head of Household	4,400
Qualifying Widow(er)	5,000

The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live.

Higher standard deduction for age (65 or older). If you do not itemize deductions, you may be entitled to a higher standard deduction if you are age 65 or older at the end of the year. You are considered 65 on the day before your 65th birthday. Therefore, you may take a higher standard deduction for 1988 if your 65th birthday was on January 1, 1989.

See the *1988 Standard Deduction Table* in this chapter to figure the standard deduction amount you are entitled to.

Higher standard deduction for blindness. If you are blind on the last day of the year and you do not itemize deductions, you may be entitled to a higher standard deduction than shown in the above table. You qualify for this benefit if you meet the following conditions.

If you are *totally blind*, attach a statement to this effect to your return.

If you are *partly blind*, you must submit with your return each year a certified statement from an eye physician or registered optometrist that:

1) You cannot see better than 20/200 in the better eye with glasses or contact lenses, or
2) Your field of vision is not more than 20 degrees.

If your eye condition will never improve beyond these limits, you can avoid having to get a new certified statement every year by having the examining eye physician include this fact in the certification you attach to your return. In later years just attach a statement referring to the certification. You should keep a copy of the certification in your records.

If your vision can be corrected beyond these limits only by contact lenses that you can wear only briefly because of pain, infection, or ulcers, you may take the higher standard deduction for blindness if you otherwise qualify.

Standard deduction for spouse. You may take a higher standard deduction amount for your spouse if your spouse is age 65 or older or blind and:

1) You file a joint return, or
2) You file a separate return and your spouse had no gross income and could not be claimed as a dependent by another taxpayer.

Note. You may not claim a higher standard deduction amount for an individual, other than your spouse, for whom you can claim an exemption.

If you decide to take the standard deduction, you may find your standard deduction amount by referring to the *1988 Standard Deduction Table* in this chapter. This table, however, does not apply to taxpayers who can be claimed as dependents. Those taxpayers should see *Standard Deduction for Dependents*, later.

After you find your standard deduction amount, enter it on line 16 of Form 1040A or line 34 of Form 1040. If you use Form 1040EZ, you may not enter more than $3,000 on line 4 (Form 1040EZ). If your standard deduction amount is more than $3,000, you must file Form 1040A or Form 1040.

Example 1. Larry, 45, and Donna, 42, are filing a joint return for 1988. Neither is blind. They decide not to itemize their deductions. Their standard deduction is $5,000.

Example 2. Assume the same facts as in *Example 1*, except that Larry is blind at the end of 1988. Larry and Donna's standard deduction is $5,600.

Example 3. Bill and Terry are filing a joint return for 1988. Both are over age 65. Neither is blind. If they do not itemize deductions, their standard deduction is $6,200.

Standard Deduction for Dependents

The standard deduction for an individual who can be claimed as a dependent on another person's tax return is generally limited to the greater of (a) $500, or (b) the individual's earned income for the year (but generally not more than $3,000).

1988 Standard Deduction Table

Caution. This table does not apply to taxpayers who can be claimed as dependents. See page 122.

STEP 1. Check the correct number of boxes below.

You	65 or older ☐	Blind ☐
Your Spouse	65 or older ☐	Blind ☐

Total number of boxes you checked .... ______

STEP 2. Find your standard deduction.

If your filing status is:	and number of boxes you checked in Step 1 above are:	your standard deduction is:
Single	0	$3,000
	1	3,750
	2	4,500
Married filing jointly	0	$5,000
	1	5,600
	2	6,200
	3	6,800
	4	7,400
Married filing separately *	0	$2,500
	1	3,100
	2	3,700
	3	4,300
	4	4,900
Head of household	0	$4,400
	1	5,150
	2	5,900
Qualifying widow(er)	0	$5,000
	1	5,600
	2	6,200

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* If your spouse itemizes deductions on a separate return, your standard deduction is zero.

Exhibit A

Standard Deduction Table
For dependents
Who have earned income of
$500 or less

Filing Status	*Standard Deduction*
Single	
Under 65 and not blind	$ 500
65 or older or blind	$1,250
65 or older and blind	$2,000
Married Filing Separately*	
Under 65 and not blind	$ 500
65 or older or blind	$1,100
65 or older and blind	$1,700

* If dependent's spouse itemizes deductions, dependent's standard deduction is zero.

Exhibit B

Worksheet
For dependents
Who have earned income of
More than $500 and
Who are under 65 and not blind

1. Enter dependent's earned income .... ______
2. Enter appropriate amount from the table below .... ______

Dependent's filing status	*Amount*
Single	$3,000
Married filing separately	$2,500

3. Compare the amounts on lines 1 and 2. Enter the smaller amount. If dependent's spouse itemizes deductions on a separate return, enter zero (0). This is the ***dependent's standard deduction*** .... ______

Exhibit C

Worksheet
For dependents
Who have earned income of
More than $500 and
Who are 65 or older or blind

1. Enter dependent's earned income .... ______
2. Enter appropriate amount from table below .... ______

Dependent's filing status	*Amount*
Single	
65 or older or blind	$ 750
65 or older and blind	$1,500
Married filing separately	
65 or older or blind	$ 600
65 or older and blind	$1,200

3. Add amounts on lines 1 and 2 and enter total here .... ______
4. Enter appropriate amount from table below .... ______

Dependent's filing status	*Amount*
Single	
65 or older or blind	$3,750
65 or older and blind	$4,500
Married filing separately	
65 or older or blind	$3,100
65 or older and blind	$3,700

5. Compare the amounts on lines 3 and 4. Enter the smaller amount. If dependent's spouse itemizes deductions on a separate return, enter zero (0). This is the ***dependent's standard deduction*** .... ______

However, if you are a dependent who is 65 or older or blind, your standard deduction may be higher.

If you are a dependent with earned income of **$500 or less**, use *Exhibit A* in this chapter to determine your standard deduction.

If you are a dependent with earned income of **more than $500** and you are under age 65 and not blind, use *Exhibit B* in this chapter to determine your standard deduction.

If you are a dependent with earned income of **more than $500** and you are **age 65 or older or blind**, use *Exhibit C* in this chapter to determine your standard deduction.

Earned income is salaries, wages, professional fees, and other amounts received as pay for work you actually perform.

Earned income includes any part of a **scholarship or fellowship grant** that you must include in your gross income. See Chapter 13 for more information.

After you find your standard deduction amount, enter it on line 16 of Form 1040A or line 34 of Form 1040. If you use Form 1040EZ, you may not enter more than $3,000 on line 4 (Form 1040EZ). If your standard deduction amount is more than $3,000, you should file Form 1040A or Form 1040.

Example 1. Michael, who is single, is claimed as a dependent on his parent's 1988 tax return. He has interest income of $600 and wages of $150. He has no itemized deductions. His standard deduction is $500 because the greater of $500 or his earned income ($150) is $500. See *Exhibit A.*

Example 2. Joe, a 22-year-old full-time college student, is claimed as a dependent on his parents' 1988 tax return. Joe is married and files a separate return. His wife does not itemize deductions on her separate return.

Joe has $1,500 in interest income and wages of $2,900. He has no itemized deductions. His standard deduction is $2,500, because the greater of $500 or his earned income ($2,900) is $2,900, but his standard deduction cannot be more than $2,500 (the maximum allowable standard deduction for a dependent under 65 and not blind who files a separate return). See *Exhibit B.*

Example 3. Amy, who is single, is claimed as a dependent on her parents' 1988 tax return. She is 18 years old and blind. She has interest income of $900 and wages of $3,000. She has no itemized deductions. Her standard deduction is $3,750, which is her earned income of $3,000 plus $750 because she is a single person who is under 65 and blind. See *Exhibit C.*

Who Should Itemize

Some taxpayers should itemize their deductions because it will help save them money. Others should itemize because they do not qualify for the standard deduction, as discussed earlier.

You should itemize your deductions if the total of your itemized deductions is more than the standard deduction to which you would otherwise be entitled.

You may benefit from itemizing your deductions on Schedule A of Form 1040 if you:

- Do not qualify for the standard deduction, or the amount you can claim is limited,
- Had large uninsured medical and dental expenses during the year,
- Paid interest and taxes on your home,
- Had large unreimbursed employee business expenses or other miscellaneous deductions,
- Had large casualty or theft losses not covered by insurance,
- Made large contributions to qualified charities, or
- Your total itemized deductions are more than the highest standard deduction to which you are otherwise entitled.

If you decide to itemize your deductions, complete Schedule A and attach it to your Form 1040. Enter the amount from Schedule A, line 26, on Form 1040, line 34 and check the box.

Changing your mind. If you do not itemize your deductions and later find that you should have itemized—or if you itemize your deductions and later find you should not have—you may change your return by filing Form 1040X, *Amended U.S. Individual Income Tax Return.* See Chapter 1 for more information on amended returns.

If you are married and filed separate returns, you may change methods of taking deductions only if you and your spouse both make the same changes. Both of you must file a consent to assessment for any additional tax either one may owe as a result of the change.

You and your spouse should use the method that gives you the lowest total tax, even though one of you may pay more tax. You **both must use the same method** of claiming deductions. If one itemizes deductions, the other should itemize because he or she will not qualify for the standard deduction (see *Persons not eligible for the standard deduction,* earlier).

23. Medical and Dental Expenses

You may include certain medical and dental expenses—for yourself, your spouse, and your dependents—only if you itemize your deductions on Schedule A (Form 1040). You must reduce your medical expenses by reimbursements received for those expenses. See *Reimbursements of Expenses,* later.

Expenses paid for medical care include those payments you make for the diagnosis, treatment, or prevention of disease, or for treatment affecting any part or function of the body. Include in medical expenses the cost of transportation for needed medical care. Also include payments for medical insurance that provides coverage for yourself, your spouse, and your dependents.

There are limits on the amounts you may deduct. You may deduct only the part of your medical and dental expenses that is more than 7.5% of your adjusted gross income shown on line 32, Form 1040. See *How to Figure Your Deduction,* later.

Check List for Medical Expenses

Use the following list for a ***quick check*** of expenses that you may include as medical expenses. These and other expense items are described more fully later in this chapter under *Medical and Dental Expenses.*

You May Include

Fees for medical services
Fees for hospital services
Meals and lodging provided by a hospital during medical treatment
Medical and hospital insurance premiums
Special equipment, such as a motorized wheelchair, etc.
Special items, including false teeth, artificial limbs, eyeglasses, hearing aids, crutches, etc.
Transportation for needed medical care
Medicines and drugs that required a prescription, and insulin
Pills or other birth control items your doctor prescribed

Do Not Include

Bottled water
Diaper service
Funeral, burial, or cremation expenses
Health club dues
Household help
Illegal operation or treatment
Life insurance or income protection policies
Maternity clothes
Medicare insurance (Medicare A) basic cost
Medicine or drugs you bought without a prescription
Nursing care for a healthy baby
Program to stop smoking
Toothpaste, toiletries, cosmetics, etc.
Trip for general improvement of health
Weight loss program

Medical and Dental Expenses

After you have reduced your medical and dental expenses by any payments received from insurance or other sources, put the amount you paid for your ***medicines and drugs*** that required a prescription, or for insulin, on line 1a, Schedule A (Form 1040).

A prescribed drug is one which requires a prescription by a doctor for its use by an individual.

Also enter on line 1a the fees you paid for doctors, dentists, nurses, and hospitals, along with the amount you paid for medical insurance. Enter amounts you paid for other expenses on line 1b. Include hearing aids, dentures, eyeglasses, transportation, and lodging.

In addition to those expense items listed earlier under *Check List for Medical Expenses,* include as medical expenses your payments for—

Medical services by doctors, surgeons, dentists, osteopaths, ophthalmologists, optometrists, acupuncturists, chiropractors, chiropodists, podiatrists, psychiatrists, psychologists, Christian Science practitioners, and others.

Hospital services, therapy and nursing services (including nurses' meals you pay for), ambulance hire, and laboratory, surgical, obstetrical, diagnostic, dental, and X-ray fees.

A legal abortion.

An operation legally performed to make a person unable to have children.

A face lift or other cosmetic surgery.

Medical care included in the tuition fee of a college or private school if a breakdown of the charges is included in the bill or given by the school.

A life-care fee or a "founder's fee" paid either monthly or as a lump sum under an agreement with a retirement home. The part of the fee payment you include is the amount properly allocable to medical care. The agreement must require a specified fee payment as a condition for the home's promise to provide lifetime care that includes medical care.

Treatment at a center for drug addicts or alcoholics, including meals and lodging provided by the center during the course of treatment.

Surgical, hospital, laboratory, and transportation ***expenses for a donor*** or a possible donor of a kidney or other organ.

Wages for an attendant who provides nursing services. You also may include in medical expenses other amounts you paid for nursing services, including amounts you paid for the attendant's meals.

Services need not be performed by a nurse as long as the services are of a kind generally performed by a nurse. This includes services connected with caring for the patient's condition, such as giving medication or changing dressings, as well as the bathing and grooming of the patient.

Divide the food expense among the household members to find the cost of the attendant's food. If you had to pay additional amounts for household upkeep because of the attendant, include as a medical expense the extra amount you paid. This includes items such as extra rent you paid because you moved to a larger apartment to provide space for the attendant, or the extra cost of utilities for the attendant. If the attendant also provided personal and household services, you must further divide these amounts between the time spent in performing household and other personal services and the time spent on nursing services. Only the amount spent for nursing services is a medical expense.

However, certain expenses for household services or for the care of a qualifying individual incurred to allow you to work may qualify for the child and dependent care credit. See Chapter 33.

Social security tax for a worker who provided medical care. For information on how to figure social security tax as well as other taxes you may be required to pay or withhold, see Publication 926, *Employment Taxes for Household Employers.*

Psychiatric care. You may include the cost of supporting a mentally ill dependent at a specially equipped medical center where the dependent receives medical care.

You also may include your transportation expenses for regular visits that are recommended as part of the dependent's treatment.

Do ***not*** include payments for psychoanalysis that is required as part of your training to be a psychoanalyst.

Special care for the handicapped. The costs of sending a mentally or physically handicapped person to a special school or home, including certain advance payments for lifetime care, may be included in medical expenses. See Publication 502 for more information about medical care expenses for the handicapped person. Enter the amount you paid for special care on line 1b, Schedule A (Form 1040).

Capital expenses. You may include in medical expenses all or part of the amounts you pay for special equipment installed in your home or for improvements, if the main reason is for medical care. The amount of your medical expense deduction, however, will depend on the extent to which the equipment or improvement has increased the value of the property. Publication 502 contains additional information, examples, and a capital expense work chart to assist you in figuring the amount of the capital expense that you may include in your medical expenses. See Publication 502 for information about expenses for operation and upkeep of such capital expense items. Publication 502 also contains information about improvements, for medical reasons, to property rented by a handicapped person. Include all of these expenses on line 1b, Schedule A (Form 1040).

Do not include in medical expenses the cost of the following items, even if they are related to medical care—

A trip taken for a change in environment, improvement of morale, or general improvement of health, even if you make the trip on the advice of a doctor.

A part of car insurance premiums that provides medical insurance coverage for all persons injured in or by your car.

A weight loss program, even if your doctor advises the program for your general health.

A program to stop smoking that you join at the suggestion of your doctor for the improvement of your general health.

Health club dues, YMCA dues, steam baths, or vacations for your general health or to relieve physical or mental discomfort that is not related to a particular disease or defect.

Household help, even if your doctor has recommended it because you are physically unable to do housework.

Salary of a practical nurse for the care of a normal and healthy baby, even if the baby's mother died in childbirth. However, you may be able to take a credit for child care expenses. See Chapter 33.

Social activities, such as dancing or swimming lessons, for the general improvement of your health, even if your doctor recommended these activities.

Impairment-related work expenses. Certain unreimbursed expenses may appear to be ***deductible as either medical or employee business expenses.*** Deduct them as employee business expenses on Schedule A, line 25, as miscellaneous deductions if they are—

Impairment-related work expenses and

Necessary for you to do your job satisfactorily,

For goods or services not generally needed or used in your personal activities, and

Not specifically covered under other income tax laws.

Example. You are blind and to do your work you must use a reader. You use the reader both during your regular working hours at your place of work and outside of your regular working hours away from your place of work. The reader's services are only for your work. You may deduct your unreimbursed expenses for the reader as an employee business expense under *Other Miscellaneous Deductions* on line 25 of Schedule A (Form 1040). See Publication 529, *Miscellaneous Deductions,* for more information about claiming the expenses of producing income.

See Publication 502 for more information on expenses that may be impairment-related work expenses.

Medical Insurance Premiums

Include the total amount you paid for medical insurance on line 1a, Schedule A (Form 1040).

Include insurance premiums you pay for policies that provide for the payment or reimbursement of—

Hospitalization, surgical fees, and other medical and dental expenses.

Prescription drugs.

Replacement of lost or damaged contact lenses.

Membership in an association that gives cooperative or so-called "free-choice" medical service, or group hospitalization and clinical care.

If you have a policy that provides more than one kind of payment, you may include the premiums for the medical care part if the charge for the medical part is reasonable. The cost of that part must be stated separately in the insurance contract or given to you in a separate statement.

Medicare A. Medicare A premiums you voluntarily pay to obtain basic hospital insurance are medical expenses.

Although part of the social security tax and self-employment tax is for Medicare A, you cannot deduct that amount.

Medicare B. Medicare B is supplementary medical insurance for the aged. If you applied when you were first eligible at age 65, you may include the Medicare B monthly basic premium rate of $24.80 from January through December multiplied by the number of months in 1988 you were enrolled. Your monthly premium may be more if you were over age 65 when you first enrolled. Check the information you received from the Social Security Administration to find out your premium.

Prepaid insurance. Premiums you pay before you are 65 for insurance covering medical care—for yourself, your spouse, or a dependent—after you are 65 are medical care expenses. These premiums are included in your medical expenses in the year paid if they are payable in equal yearly installments, or more often, and paid for at least 10 years, or until you reach 65, but not for less than 5 years.

Premiums paid for a retired employee. Under certain employer health plans, you may continue to participate in the health plan after you retire. You may either receive a cash payment for unused sick leave or have the payment applied to the cost of insurance. If you retire under such a plan, you must include the value of the unused sick leave in your income. You include the payment to the health insurance plan as a medical insurance premium. But, if you retire under an employer health plan which provides that your employer automatically apply the unused sick leave to your health insurance premiums, you do not include the value of the unused sick leave in your income. You may not include the premiums paid with unused sick leave as a medical expense.

Health insurance costs for self-employed individuals. If you are self-employed in 1988, you may deduct as a business expense on line 26 of Form 1040, rather than on Schedule A, up to 25% of the amount you pay for medical insurance for yourself and your family. The balance of the cost is included with your other medical care expenses as an itemized deduction subject to the 7.5% limitation. The 25% deduction must be equal to or less than the net earned income from your business. Use the worksheet that follows to figure your deduction. This deduction is repealed for tax years beginning after 1989.

However, if you are also an employee of another person, you may not take this special 25% deduction for your medical insurance costs if you are eligible to participate in a subsidized health plan maintained by your employer. You also cannot take this special 25% deduction if your spouse is employed, and you are eligible to participate in your spouse's subsidized health plan.

Worksheet for Self-Employed Health Insurance Deduction

(Keep for your records)

1. Enter amount paid for health insurance in 1988 for you, your spouse, and dependents .... ______
2. Percentage used to figure the deduction x .25
3. Multiply the amount on line 1 by the percentage on line 2 .... ______
4. Enter your net profit from self-employment (from Schedule C and F (Form 1040), Schedule K-1 (Form 1065), and any other earned income*) minus any deduction you claim on Form 1040, line 27 .... ______
5. Compare the amounts on lines 3 and 4. Enter the **smaller** of the two amounts here and on Form 1040, line 25. (**DO NOT** include this amount in figuring any medical expense deduction on Schedule A (Form 1040) .... ______

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* **Earned income** includes net earnings and gains (other than capital gains) from the disposition, transfer, or licensing of property you created.

Caution: As this publication was being prepared for print, Congress was considering legislation that would limit the deduction to the earned income from the trade or business in which the health insurance plan is established. For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Do not include premiums you pay for—

Life insurance policies, or policies providing repayment for loss of earnings or for the accidental loss of life, limb, sight, etc.

Policies that pay a guaranteed amount each week for a stated number of weeks if you are hospitalized for sickness or injury.

Meals and Lodging

Payment for meals and lodging provided by a hospital or similar institution as a necessary part of medical care is a medical expense if the main reason for being in the hospital is to receive medical care. Include your payment for meals and lodging provided by hospitals on line 1a, Schedule A (Form 1040).

You may also include in medical expenses the cost of lodging (not provided in a hospital or similar institution) while away from home if:

- The lodging is primarily for and essential to medical care,
- Medical care is provided by a doctor in a licensed hospital or in a medical care facility related to, or the equivalent of, a licensed hospital,
- The lodging is not lavish or extravagant under the circumstances, and
- There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount you include in medical expenses may not exceed $50 for each night for each person. Lodging is included for a person for whom transportation expenses are a medical expense because that person is traveling with the person receiving the medical care, for example, a parent traveling with a sick child. In that case up to $100 per night for lodging is included as a medical expense. Include your payment for these lodging expenses on line 1b, Schedule A (Form 1040).

Nursing home. If you, your spouse, or your dependent is in a nursing home or a home for the aged, and the main reason for being there is to get medical care, you may include as a medical expense the entire cost, including meals and lodging. Include the amount you pay on line 1a, Schedule A.

Do not include the cost of meals and lodging if you, your spouse, or your dependent is in the home mainly for personal or family reasons. In that case, you may include as a medical expense only the part of the cost that is for medical or nursing care.

Medical trip. You may not include the cost of your meals and lodging while you are away from home for medical treatment that you do not receive at a medical facility, or for the relief of a specific condition, even if the trip is made on the advice of your doctor.

Example. You have been ill with a heart condition. You live in an area that has extremely cold winters, which makes your condition worse. Your doctor advises you to spend the winter in a warmer place. You and your family spend the winter in a rented house in Florida. The trip is made for a specific medical reason. You may include in medical expenses ***your share of the transportation expenses*** between your home and Florida. You may not include your family's transportation expenses. You may not include any of the expenses for food and rooms while you are between your home and Florida, or while you are in Florida.

Transportation

Amounts paid for transportation primarily for and essential to medical care qualify as medical expenses. Enter the amount you paid for transportation on line 1b, Schedule A (Form 1040).

You may include payments for—

Bus, taxi, train, or plane fare, or for ambulance service.

Out-of-pocket expenses for your car, such as gas and oil. You may not include depreciation, insurance, general repair and maintenance expenses.

If you do not want to figure your actual expenses, you may use a standard rate of 9 cents a mile for each mile you use your car for medical reasons.

Either way, you may include the cost of parking fees and tolls.

Transportation expenses of a parent who must go with a child to get medical care.

Transportation expenses of a nurse or other person who can give injections, medications, and other treatment required by a patient who is traveling to get medical care and who cannot travel alone.

Do not include—

Transportation expenses to and from work even if your condition requires an unusual means of transportation.

Transportation costs if, for nonmedical reasons, you choose to travel to another city, such as a resort area, for an operation or other medical care prescribed by your doctor.

Special Items and Equipment

Enter the amounts you paid for special items and equipment on line 1b, Schedule A (Form 1040).

Include payments for—

False teeth, artificial limbs, contact lenses, eyeglasses, hearing aids, and crutches.

The cost and care of guide dogs for the blind or deaf. These expenses are medical, not business, even if you use the dog in your business.

The part of the cost of braille books and magazines that is more than the price for regular books and magazines.

The cost and repair of special telephone equipment that lets a deaf person communicate over a regular telephone.

The extra cost of a specially equipped television set and the cost of an adapter for a regular set that provides subtitles for a deaf person.

Oxygen equipment and oxygen to relieve problems in breathing caused by a medical condition.

Special equipment, such as a motorized wheelchair or autoette, special hand controls and other special equipment installed in a car for the use of a physically handicapped person. Include the amount by which the cost of a car specially designed to hold a wheelchair is more than the regular cost of the car.

Operating and keeping up an autoette or wheelchair used mainly for the relief of sickness or disability, and not just to go to and from work.

Do not include the cost of operating a specially equipped car, except as discussed earlier under *Transportation.*

Removing lead-based paints from walls and woodwork in a home to prevent a child who has or had lead poisoning from eating the paint. The areas covered with lead-based paint have to be in poor repair (peeling or cracking) or be within the child's reach. You may not include in medical expenses the cost of repainting the scraped area.

If you do not scrape these areas but cover them with wallboards or paneling, the cost of putting in these items is a capital expense. See *Capital expenses*, discussed earlier. Do not include the cost of painting the new wallboards in medical expenses.

Spouse, Dependents, and Others

This section explains deductions for medical expenses that you pay for your spouse and your dependents (including a person you could have claimed as a dependent, but who did not meet the gross income or joint return tests discussed in Chapter 3). Medical expenses for a spouse or dependent who died (decedent) are also explained.

Medical expenses and child and dependent care expenses. Some disabled dependent care expenses may qualify as medical expenses or as work-related expenses for purposes of taking a credit for dependent care. For information, see Chapter 33.

Spouse

You may include medical expenses you paid for your spouse if you were married at the time the expenses were incurred or when you paid the bills.

Example 1. Mary incurred medical expenses before she and Bill were married. Bill paid those expenses after they were married. He may include them in figuring his medical expense deduction, even if he and Mary file separate returns.

Example 2. In Example 1, if Mary had paid her own medical bills before they were married, and if the couple filed separate returns, Bill could not include Mary's medical expenses. Mary would include all the medical expenses she paid during the year on her separate return. If they filed a joint return, they would include the medical expenses they both paid.

Example 3. During 1988, John paid medical expenses for his wife Louise, who died during 1987. He remarried and is filing a joint return with Belle, his second wife. Because he was married to Louise when the medical expenses were incurred, he may include them in his medical expenses for 1988. He may do this even though he was no longer married to Louise when he paid the bills, and he is filing a joint return with Belle.

Dependents

You may include medical expenses you paid for a person who was your dependent at the time the medical services were provided or the expenses were paid. You also may include medical expenses for a person you could claim as a dependent except that the person had income of $1,950 or more, or filed a joint return.

Example 1. You provided more than half the support of your 22-year-old son, including his medical expenses of $800. Because he is not a student and he earned more than $1,950, you may not claim him as a dependent. In figuring your medical expenses, you may include the $800 medical expenses that you paid for your son.

Example 2. You provided more than half the support of your married daughter, including her medical expenses of $1,200. She and her husband must file a return. They file a joint return. Although you may not claim an exemption for your daughter, you may include in your medical expenses the $1,200 medical expenses you paid for her.

Adopted child. Include pre-adoption medical expenses if the child qualified as your dependent when the medical expenses were provided or when you paid those expenses.

If you pay back an adoption agency or other persons for medical expenses they paid under an agreement with you, you are considered to have paid those expenses. But if you pay back medical expenses incurred and paid before adoption negotiations began, you may not deduct them as medical expenses.

Child of divorced or separated parents. If either parent can claim a child as a dependent under the rules for divorced or separated parents, each parent may include the medical expenses he or she pays for the child. See *Support Test for Divorced or Separated Parents* in Chapter 3.

Multiple support. You may include medical expenses you paid for a person for whom you meet the support test under a multiple support agreement, even if you may not claim the person as a dependent because he or she had gross income of $1,950 or more. (See *Multiple Support Agreement* in Chapter 3.) If you are entitled to claim a dependent under a multiple support agreement, any medical expenses paid by other parties who joined you in the agreement—either directly or as repayment to you—may not be claimed either by them or by you.

Example. You and your three brothers each provide one-fourth of your mother's total support. Under a multiple support agreement, you claim your mother as a dependent. You paid all of her medical expenses for the current year. Your brothers repaid you for three-fourths of the total amount. In figuring your medical expense deduction, you may include only one-fourth of the total paid.

However, if you and your brothers share the nonmedical support items and you separately pay all of your mother's medical expenses, you may include the amount you paid for her medical expenses in your medical expenses.

Decedents

Expenses paid from an estate for a deceased taxpayer's medical care are treated as paid by the decedent at the time the medical services were provided if they are paid within the one-year period beginning with the day after the date of death. Do not deduct them to figure the taxable estate for federal estate tax purposes if they are claimed on the income tax return.

An amended return may be filed for the earlier year or years in which those expenses are treated as paid, unless the period for filing an amended return for the year has passed. (See *Amended Returns* in Chapter 1.) This special rule applies only to expenses incurred for the decedent's medical care. It does not apply to expenses incurred to provide medical care for the decedent's dependents.

Example. John Smith died on June 1, 1988. His unpaid medical expenses include $1,500 incurred in 1987 and $2,000 in 1988. Mr. Smith filed his 1987 income tax return on April 15, 1988. His executor paid the $3,500 in medical expenses in January 1989.

The executor may file an amended return for 1987, claiming the $1,500 medical expenses treated as paid in that year as a deduction. The increase in medical expenses for 1987 will result in a refund. The $2,000 incurred in 1988 and treated as paid in that year may be included on the final return, although it was not paid until after Mr. Smith's death.

Deduction not claimed on estate tax return. If the expenses paid are deductible on the estate tax return, but you as the executor or surviving spouse want to deduct them on the decedent's income tax return, you must file a statement with Form 1040 or Form 1040X showing that the amount has not been claimed on the estate tax return and will not be claimed as an estate tax deduction.

Expenses paid by a widow or widower for the medical care of the deceased spouse are included as medical expenses in the year they are paid, whether they are paid before or after the decedent's death.

Deceased dependent's medical expenses. Include a deceased dependant's medical expenses in the year they are paid, whether they are paid before or after death.

How to Figure Your Deduction

To figure your medical expense deduction, complete Schedule A (Form 1040). Write in the amounts you paid for medical and dental care expenses after you reduce these expenses by any payments received from insurance or other sources. You may deduct only your medical and dental expenses that are more than 7.5% of your adjusted gross income shown on line 32, Form 1040.

Separate returns. If you and your spouse do not live in a community property state and you file separate returns, each of you may deduct only the medical expenses you actually paid. Any medical expenses paid out of a joint checking account in which you and your spouse have the same interest are considered to have been paid equally by each of you, unless you can show otherwise.

If you and your spouse live in a community property state and file separate returns, divide equally any amounts you paid for medical expenses out of community income. Each of you may deduct half of the expenses. If medical expenses are paid out of the separate funds of one spouse, only the spouse who paid the medical expenses may deduct them. For more information, see Publication 555, *Community Property and the Federal Income Tax.*

When to deduct. You may deduct medical expenses only in the year you paid them. But see *Decedents*, earlier. If you pay medical expenses by check, the day you mail or deliver the check is the date of payment. If you use a "pay-by-phone" account, the date reported on the statement of the financial institution showing when payment was made is the date of payment.

If you charge medical expenses to your credit card, deduct the expenses in the year the charge is made. It does not matter when you actually pay the amount charged.

Itemized deductions. You may claim a medical expense deduction only if you itemize your deductions on Schedule A (Form 1040). You may not claim a medical expense deduction if you use Form 1040EZ or Form

1040A. For an example, see *Medical and dental expenses (lines 1a–4, Schedule A)* under *Itemized Deductions (Schedule A)* in Chapter 38.

Reimbursements of Expenses

Reduce total medical expenses for the year by the total reimbursements (repayments) received from insurance or other sources for medical expenses during the year before you apply the 7.5% limit. This includes payments received from Medicare. It does not matter if the reimbursement is paid to the patient or to the doctor, hospital, etc.

Example. Your doctor and hospital bills amounted to $4,690, and prescribed medicines and drugs cost you an additional $420—a total of $5,110 for the year. You also paid $350 during the year for medical insurance. Your hospitalization insurance paid $3,752 for doctor and hospital bills and $240 for medicines and drugs. Your adjusted gross income was $17,000. You figure your deduction as follows:

Total cost of medicines and drugs ($420 – $240 reimbursement)	$ 180
Insurance premiums	350
Doctor and hospital bills ($4,690 – $3,752)	938
Total medical expenses	$1,468
Minus: 7.5% of $17,000	1,275
Balance	$ 193

Accident insurance. You must reduce your medical expenses by the part of the payments you get from an insurance policy that repays you for hospitalization and medical care. See *Excess reimbursement* if the repayment of medical expenses is more than the expenses you had.

Do not reduce medical expenses by any repayments you received for loss of earnings or damages for personal injury.

Damages. If you receive an amount in settlement of a personal injury suit, the part that is for medical expenses that you deducted in an earlier year must be included as income in the later year if your medical deduction in the earlier year reduced your income tax in that year.

Future medical expenses. If you receive an amount in settlement of a damage suit for personal injuries that is properly allocable or determined to be for future medical expenses, you must reduce any medical expenses you pay this year and in future years because of these injuries until the amount you receive in settlement has been completely used. You may include amounts you pay after that in your medical expenses.

Excess reimbursement. If the total reimbursement you received from your medical insurance policy or plan during the year is the same as or more than your total medical expenses for the year, you may not take a medical deduction. The amount of insurance payments or other reimbursements you receive that is more than your total medical expenses for the year is an excess reimbursement. The need to include excess reimbursement in income depends on whether your employer paid the medical insurance premiums or the cost of a similar plan.

Premiums paid by employee. If you paid the whole premium on your medical insurance policy or all of the cost of a similar plan, you do not include an excess reimbursement in your gross income.

Premiums paid by you and your employer. If you and your employer both contribute to your medical insurance plan, include in your income the part of your excess reimbursement that is from your employer's contributions which were not included in your income.

Example. You are covered by your employer's medical insurance policy. The annual premium is $2,000. Your employer pays $600 of that amount and the balance of $1,400 is taken out of your wages. The part of any excess reimbursement you receive under the policy that is from your employer's contributions is figured as follows:

Total annual cost of policy	$2,000
Amount paid by employer	$ 600
Employer's contribution in relation to the annual cost of the policy ($600/$2,000)	30%

You must include in your gross income 30% of the excess reimbursement you received for medical expenses under the policy.

Premiums paid by your employer. If your employer, or your former employer if you are retired, pays the total cost of your medical insurance plan and your employer's contributions are not included in your income you must report all of your excess reimbursements as income. See Chapter 6 for more information about whether the medical premiums paid by your employer are exempt from tax.

More than one policy. If you receive reimbursement from more than one policy and the costs of the policies are paid by both you and your employer, you must first divide the medical expense among the policies to figure the excess reimbursement from each policy. Then divide the policy costs to figure the part of any excess reimbursement that is from your employer's contribution.

Example. You are covered by your employer's health insurance policy. The annual premium is $1,200. Your employer pays $300, and the balance of $900 is deducted from your wages. You also paid the whole premium ($250) for a personal health insurance policy.

During the year you paid medical expenses of $3,600. In the same year, you were reimbursed $2,500 under your employer's policy and $1,500 under your personal policy.

You figure the part of any excess reimbursement you receive that is from your employer's contribution as follows:

Reimbursement from employer's policy	$2,500
Reimbursement from your policy	1,500
Total reimbursement	$4,000

Amount of medical expenses from your policy ($1,500/$4000 × $3,600 total medical expenses)	$1,350
Amount of medical expenses from your employer's policy ($2,500/$4,000 × $3,600 total medical expenses)	2,250
Total medical expenses	$3,600
Excess reimbursement from your employer's policy ($2,500 – $2,250)	$ 250

Because both you and your employer contribute to the cost of this policy, you must divide the costs again to determine the excess reimbursement from your employer's contribution.

Employer's contribution in relation to the annual cost of the policy ($300/$1,200)	25%

You must report as income 25% of the excess reimbursement of $250, or $62.50, that is from your employer's contribution.

Reimbursement in a later year. If you are reimbursed in a later year for medical expenses you deducted in an earlier year, you must report the reimbursement as income in the later year. However, do not report more than the amount you previously deducted as medical expenses. Also, you may further exclude the recovery from income up to the amount of the deduction that did not reduce the amount of income tax imposed on you in the year you deducted the medical expenses.

Example. You are single and had adjusted gross income in 1987 of $15,000. During that year you had medical expenses of $1,600 and paid medical insurance premiums of $400. No amount was included for prescribed medicines and drugs. You deducted $875, figured as follows:

Insurance premiums	$ 400
Medical expenses	1,600
Total	$2,000
Minus: 7.5% of adjusted gross income	1,125
Total medical expense deduction	$ 875

Your itemized deductions, including your medical expenses, were $3,200.

In 1988, you collected $600 under your insurance policy as reimbursement for part of your 1987 medical expenses. If you had collected the reimbursement in 1987, your deduction for medical expenses in 1987 would have been only $275, figured as follows:

Insurance premiums	$ 400
Medical expenses	1,600
Total	$2,000
Minus: Insurance payments	600
Balance	$1,400
Minus: 7.5% of adjusted gross income	1,125
Total medical expense deduction	$ 275

Your $875 medical expense deduction in 1987 reduced your income tax in that year. Therefore, you must include the $600 of insurance reimbursement in income in 1988. Report the $600 on line 22, Form 1040, in 1988.

If your medical expense deduction did not reduce your income tax in 1987, all or part of the reimbursement may be excluded from your income in 1988. For more information about the recovery of an amount that you claimed as an itemized deduction in an earlier year, see Chapter 13.

Medical expenses not deducted. If you did not deduct a medical expense in the year you paid it because you did not itemize deductions or because your medical expenses were not more than the 7.5% limit (5% under prior law), you should not include in income the reimbursement for this expense that you receive in a later year. However, if the reimbursement is more than the expense, see *Excess reimbursement,* discussed earlier.

Example. In 1988, you have medical expenses of $500. You cannot deduct the

$500 because it is not more than the 7.5% limit. If in a later year you are reimbursed for any of the $500 medical expenses, you do not include the reimbursement in your gross income.

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24. Taxes

If you itemize deductions on Schedule A (Form 1040), you can deduct certain taxes you pay during your tax year.

Deductible taxes include:

Income tax (state, local, or foreign).

Real property (real estate) tax (state, local, or foreign).

Personal property tax (state or local).

You can also deduct state, local, and foreign taxes, including sales taxes, not listed above if you paid or accrued them as part of an expense in an activity for the production of income or in carrying on a trade or business. In some cases, however, these taxes are deducted not on Schedule A, but on other schedules or forms. See *Where to Deduct*, later.

State or local taxes are those imposed by the 50 states, U.S. possessions, or any of their political subdivisions (such as a county or city), or by the District of Columbia. An Indian tribal government and any of its subdivisions that are recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for this purpose. Therefore, any of the state and local taxes mentioned above that are imposed by an Indian tribal government or by any of its subdivisions that have been so recognized by the Secretary will be deductible when paid.

Foreign taxes are taxes imposed by a foreign country or any of its political subdivisions.

The tax must be imposed on you. Generally, you can deduct only taxes that are imposed on you.

Property taxes. Generally, you can deduct property taxes only if you are the property owner. If real estate taxes are paid by your spouse who owns a home, they are deductible on your spouse's separate return or on your joint return.

The tax must be paid. To be deductible, the tax must be paid during your tax year. You may deduct only those taxes paid during the calendar year for which you file a return. If you pay your taxes by check, the day you mail or deliver the check is generally the date of payment. If you use a pay-by-phone account, the date reported on the statement of the financial institution showing when payment was made is the date of payment.

If you question a tax liability and use the cash method of accounting, you can deduct the tax only in the year you actually pay it. If you use the accrual method of accounting, you must use special rules for determining when you can deduct the tax liability you are questioning. See *Contested Liabilities* in Publication 538, *Accounting Periods and Methods*, for more information.

General sales taxes. You cannot deduct state and local sales tax. However, any sales tax paid or accrued on the purchase of property is added to the cost of the property. For more information, see Chapter 15. If you have a trade or business and buy property whose cost is deductible as a business expense, such as supplies, the sales tax on that purchase is deductible as part of the business expense.

Income Taxes

You can deduct state and local income taxes, including taxes on interest income that is exempt from federal income tax. You cannot deduct state and local taxes on other exempt income. For example, the part of state income tax on a cost-of-living allowance that is exempt from federal income tax is not deductible.

State and local income taxes. Deduct state and local income taxes withheld from your salary. Deduct payments made on taxes for an earlier year in the year they were withheld or paid. Also deduct estimated payments (including any credits for an overpayment applied to estimated taxes) you make under a pay-as-you-go plan of a state or local government. However, you must have a reasonable basis for making the estimated tax payments. Any estimated state or local tax payments you make that you are in fact not required to make are not deductible. For example, if you made an estimated state income tax payment, but the estimate of your state tax liability for the year shows that you will get a refund of the full amount of your estimated payment, then you were not required to make the payment and you may not deduct it.

Refund. If you receive a refund of state or local (or foreign) income taxes in a year after the year in which you paid them, you may have to include all or part of the refund in income on line 10 of Form 1040, in the year you receive it. This includes refunds resulting from taxes that were overwithheld, not figured correctly, or figured again as a result of an amended return. If you did not itemize your deductions in the previous year, you do not have to include the refund in income. For a discussion of how much to include, see *Recoveries*, in Chapter 13.

Separate returns. If you and your spouse file separate state and separate federal income tax returns, you each may deduct on your federal return only the amount of your own state income tax.

If you file separate state returns and a joint federal return, you may deduct on your joint federal return the sum of the state income taxes both of you pay.

If you and your spouse file a joint state return and separate federal returns, each of you may deduct on your separate federal return part of the state income taxes. You may deduct only the amount of the total taxes that is proportionate to your gross income as compared to the combined gross income of you and your spouse. You may not deduct more than the amount you actually paid during the year. If you and your spouse are jointly and individually liable for the full amount of the state income tax, you and your spouse may deduct on your separate federal returns the amount you each actually paid.

Employee contributions to a state disability fund. You may deduct mandatory contributions to state disability benefit funds that provide against loss of wages. Payments made to the following disability funds are deductible as state income taxes on Schedule A (Form 1040):

California Nonoccupational Disability Benefit Fund

New Jersey Nonoccupational Disability Benefit Fund

New York Nonoccupational Disability Benefit Fund

Rhode Island Temporary Disability Benefit Fund

Employee contributions to private or voluntary disability plans are not deductible.

Employee contributions to a state unemployment fund that covers you for the loss of wages from unemployment caused by business conditions are deductible as taxes on Schedule A (Form 1040).

Foreign income taxes. You can take either a deduction or a credit for income taxes imposed on you by a foreign country or a U.S. possession. However, you cannot take a deduction or credit for foreign income taxes paid on income that is exempt from tax under the foreign earned income exclusion. For more information about the exclusion, get Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

Real Estate Taxes

Deductible real estate taxes are any state, local, or foreign taxes on real property levied for the general public welfare. They generally do not include taxes charged for local benefits and improvements that increase the value of the property.

Local benefit taxes are deductible if they are for maintenance or repair, or for interest charges related to those benefits. If only a part of the taxes is for maintenance, repair, or interest, you must be able to show the amount of that part to claim the deduction. If you cannot determine what part of the tax is for maintenance, repair, or interest, none of it is deductible.

Trash and garbage pickup fees that are included in your real estate taxes are not deductible.

Tax surcharge charged as rent. If your landlord increases your rent in the form of a tax surcharge because of increased real estate taxes, you cannot deduct the increase as taxes.

Homeowners association charges you pay for recreational facilities and for maintaining common areas are not deductible.

Tenant-shareholders in a cooperative housing corporation. You may deduct your share of the real estate taxes the corporation paid or incurred on the property. For more information, see Publication 530, *Tax Information for Homeowners*. If the corporation leases the land and buildings and pays the real estate taxes under the terms of the lease agreement, your part of the taxes is not deductible.

If you bought or sold real estate during the tax year, the real estate taxes must be divided between the buyer and the seller.

The buyer and the seller must divide the real estate taxes according to the number of days in the ***real property tax year*** (the period to which the tax imposed relates) that each owned the property. The seller pays the taxes up to the date of the sale, and the buyer pays the taxes beginning with the date of the sale, regardless of the lien dates under local law.

If you use the cash method and cannot deduct taxes until they are paid, and the buyer of your property is personally liable for the tax, you are considered to have paid your part of the tax imposed at the time of the sale. This lets you deduct the part of the tax to the date of sale even though you did not actually pay it.

Example 1. Dennis and Beth White's real property tax year is the calendar year, with payment due August 1. The tax on their old home, sold on May 5, was $620 and the tax on their new home, bought on May 4, was $732. Dennis and Beth are considered to have paid a proportionate share of the real estate taxes on the old home even though they did not actually pay them to the taxing authority. On the other hand, they may claim only the proportionate share of the taxes they paid on their new property even though they paid the entire amount.

Because Dennis and Beth held the old property for 125 days (January 1 to May 4, the day before the sale), they may deduct 125/366 of $620, or $212. They owned the new home for 242 days (May 4 to December 31, including date of purchase), so their taxes on the new home are 242/366 of $732, or $484. Their real estate tax deduction for their old and new homes is the sum of $212 and $484, or $696, which they enter on line 6 of Schedule A (Form 1040).

Example 2. George and Helen Brown's real property tax year is the calendar year. Real estate taxes for the ***previous year*** are assessed in their state on January 2. They become due on May 31 and October 31 of the following year. Under state law, the tax becomes a lien on May 31. The Browns bought a home on May 2, 1988. Real estate taxes for the year are $680. George and Helen agree to pay all taxes due after the sale. They pay $340 tax on May 31 and $340 tax on October 31. Since the taxes paid in 1988 relate to 1987, the Browns may not deduct the taxes paid but instead must add these taxes to the cost of their home. The seller adds the $680 to the amount realized on the sale and can take a $680 deduction for real estate taxes.

In January 1989, George and Helen receive their property tax statement for 1988 taxes of $752 and pay these taxes in 1989. Because George and Helen owned their new home in 1988 for 244 days (May 2 to December 31), they are entitled to a tax deduction of 244/366 of $752, or $501. The remaining $251 of taxes paid in 1989 is added to the cost of their home. The seller is entitled to a tax deduction of $251 for the 122 days the seller owned the home in 1988. The $251 also must be added to the amount realized on the sale. The seller should contact the Browns in January 1989 to get the property tax amount due and payable, as figured earlier. This information will be helpful to the seller when the seller attaches Form 2119, *Sale of Your Home,* to the tax return.

Delinquent (late) taxes charged to the seller but paid by the buyer as part of the contract price are not deductible. The buyer adds these taxes to the cost of the property.

Real estate taxes placed in escrow (put in the care of a third party). If your monthly mortgage payment includes an amount placed in escrow for real estate taxes, you may not deduct the total of these amounts included in your payments for the year. You can deduct only the amount of the tax that the lender actually paid to the taxing authority. If the lender does not notify you of the amount of real estate tax that was paid for you, contact the lender or the taxing authority to find the proper amount to show on your return.

Married filing separate return. If you and your spouse held property as tenants by the entirety, and you file separate returns, each of you may deduct only the taxes each of you paid on the property.

Minister's and military housing allowance. If you are a minister or a member of the uniformed services and receive a housing allowance that you may exclude from income, you may deduct all of the real estate taxes you pay on your home.

Personal Property Taxes

To qualify as a deductible personal property tax, a state or local tax must meet the following three tests:

1) The tax must be charged on personal property.
2) The tax must be based ***only*** on the value of the personal property.
3) The tax must be charged on a yearly basis, even if it is collected more than once a year, or less than once a year.

A tax is considered charged on personal property even if it is for the exercise of a privilege. For example, a yearly tax based on value qualifies as a personal property tax even if it is called a registration fee and is for the privilege of registering motor vehicles or using them on the highways.

Example. Your state charges a yearly motor vehicle registration tax of 1% of value plus 50 cents per hundredweight. You paid $32 based on the value ($1,500) and weight (3,400 lbs.) of your car. You may deduct $15 as a personal property tax, since it is based on the value. The remaining $17, based on the weight, is not deductible.

Expenses of Business or Producing Income

You can deduct certain taxes only if they are ordinary and necessary expenses of your trade or business or producing income. You generally must pay these taxes (expenses) during your tax year.

However, any tax paid in connection with the purchase or sale of property must be treated as part of the cost basis of the property or, in the case of a sale, as a reduction in the amount realized. If the cost of the property is a business expense, such as the cost of supplies, any tax paid is deductible as part of the business expense.

Where to Deduct

You deduct taxes on the following schedules:

Taxes that you must pay in operating your business, or on your property used in your business, are generally deducted on Schedule C (Form 1040) or Schedule F (Form 1040). For more information, get Publication 535, *Business Expenses.*

Taxes attributable to property producing rent or royalty income generally are deducted on Schedule E (Form 1040).

State and local income taxes are deducted only on Schedule A (Form 1040), even if your only source of income is from business, rents, or royalties.

Foreign income taxes you pay to a foreign country or U.S. possession can be claimed as an itemized deduction on Schedule A (Form 1040), or as a credit against your U.S. income tax. For more information, get Publication 514, *Foreign Tax Credit for Individuals.*

Occupational taxes that are charged at a flat rate by a locality for the privilege of working or conducting a business in the locality are deducted by self-employed individuals on Schedule C (Form 1040) or Schedule F (Form 1040). Occupational taxes paid by an employee are deducted on Schedule A (Form 1040) as a miscellaneous itemized deduction.

All other deductible taxes are deducted on Schedule A (Form 1040).

Taxes You May Not Deduct

Many federal, state, and local government taxes are not deductible.

Nondeductible federal taxes include:

Federal income taxes, including those withheld from your pay.

Social security or railroad retirement taxes withheld from your pay.

Social security and other employment taxes paid on the wages of your employee who performed domestic or other personal services (see *Employment taxes for household workers,* later).

Federal excise taxes or customs duties, unless they are connected with your business or income-producing activity.

Federal estate and gift taxes. However, if you must include in gross income an amount of income in respect of a decedent, the tax can be deducted as a miscellaneous deduction (see *Estate Tax Deduction* in Publication 559).

The following state or local taxes are not deductible:

General sales taxes.

Motor vehicle taxes (however, see *Personal Property Taxes,* earlier).

Inheritance, legacy, succession, or estate taxes.

Gift taxes.

Per capita or poll taxes.

Cigarette, tobacco, liquor, beer, wine, etc., taxes.

Utility taxes.

Fees and charges such as the following are not deductible:

Driver's licenses, car inspection fees, license plates (however, see *Personal Property Taxes,* earlier).

Dog tags, hunting licenses.

Marriage licenses.

Tolls for bridges and roads, parking meter deposits.

Fines (such as for parking or speeding), collateral deposits.

Water bills, sewer and other service charges.

Fuel adjustment charges by a municipally owned electric utility company.

Postage, etc.

State and local taxes on gasoline, diesel, and other motor fuels are not deductible unless the vehicles are used for business.

Taxes for improvements to property are not deductible. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment.

Transfer taxes (or stamp taxes) and other taxes and charges on the sale of a personal home are not deductible. If they are paid by the seller, they are expenses of the sale and reduce the amount realized on the sale. If paid by the buyer, they are included in the cost basis of the property. If you deduct these taxes and charges as moving expenses as explained in Chapter 28, you may not use them either to reduce the amount realized on the sale of your home or to increase the cost basis of your new home.

Employment taxes for household workers. You may not deduct the social security or other employment taxes you pay on the wages of a household worker. However, you may be able to include your share of social security and other employment taxes you pay as part of medical or child care expenses. For more information, see Chapter 23 and Chapter 33.

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25. Interest Expense

Important Change for 1988

Recent legislation changed the rules for deducting mortgage interest. Generally, how much interest you may deduct depends on when you obtained the loan and the amount of the loan.

If you obtained any loan that was secured by your main or second home before October 14, 1987, all of the interest is deductible. The amount of the loan and the use of its funds do not matter. If you obtained a loan that was secured by your main or second home after October 13, 1987, and the funds were used to buy, build, or improve that home, you can deduct all of the interest if the loan is for $1 million or less. In addition to this, you may deduct all of the interest paid on any other loans secured by your main or second home as long as the total of these loans is $100,000 or less. Generally, for loans covered by the $100,000 limit, you may use the proceeds any way you please.

For more information, see *Limit on the Deduction of Mortgage Interest,* later or for a complete discussion of mortgage interest, see new Publication 936, *Limits on Home Mortgage Interest Deduction.*

Interest is an amount paid for the use of borrowed money. To be deductible, the interest you pay must reflect the true (economic) cost of the indebtedness for the payment period. This chapter, except where noted, assumes that interest paid is the true cost.

This chapter discusses the deductibility of various kinds of nonbusiness and noninvestment interest, that is, those that are reportable on Schedule A (Form 1040). Business interest is reported on Schedules C, E, or F. Investment interest, although reportable on Schedule A, is subject to different rules. These rules are discussed in Publication 550, *Investment Income and Expenses.*

However, if you apply the proceeds of a debt to mixed uses (for example, nonbusiness/noninvestment and business/investment), you may have to allocate the interest on the debt to each use in figuring how and where it is deductible. A discussion of the permitted methods of allocation is in Publication 545, *Interest Expense.*

To deduct interest on a debt, you must be legally liable for that debt. You may not deduct payments you make for someone else if you are not legally liable to make them. Both the lender and the borrower must intend that the loan be repaid. In addition, there must be a true debtor-creditor relationship between the lender and the borrower.

Example 1. You lend money to your son, hoping to be repaid when he is able. He is not legally liable to pay you. Therefore, no true debtor-creditor relationship is created, and he may not deduct any interest paid.

Example 2. You cosign a note for a loan made by a bank to your son. Your son is a student. You and your son are jointly liable on the note. Since this is a personal loan, you may deduct 40% of the interest you pay on the loan in 1988.

If you use the cash method of accounting, as most people do, you must pay the interest in cash or its equivalent before you may deduct it. If you pay by check, the day you mail or deliver the check is the date of payment. If you use a pay-by-phone account, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You have not paid interest if the payment is made with funds obtained from the original lender through a second loan, an advance, or other financial arrangement similar to a loan.

Example. You borrow $1,000 in September 1988, payable in 90 days at 15% yearly interest. In December 1988 you make the payment with a new note from the same lender for $1,038 due the following March. If you use the cash method of accounting, you may not deduct the interest in the year you gave the new note because you did not actually pay the interest.

If you use the accrual method of accounting, you may deduct interest over the period it accrues, regardless of when you pay it. Generally, under the accrual method, you report income when you earn it, whether or not you receive it. You deduct your expenses when you incur them, rather than when you pay them.

Interest paid in advance. If you pay interest in advance for a period that goes beyond the end of the tax year, you must spread the interest over the tax years to which it applies. You may deduct in each year only the interest for that year. However, see *Points,* later.

Refunds of interest. If you receive a refund of interest in the same tax year you pay it, you must reduce your interest expense deduction by the amount refunded to you. If the interest expense is personal interest, you should reduce the expense by the amount of the refund before applying the personal interest limits. If you receive a refund of interest you deducted in an earlier year, you generally must include the refund in income in the year you receive it. But you only need to include the amount of the deduction that reduced your tax in the earlier year.

For more information, see *Recoveries* in Chapter 13.

Items You May Not Deduct

"Points," if you are a seller

Nonredeemable ground rents

Service charges (however, see *Expenses to Produce Income; Other Expenses* in Chapter 30)

Loan fees

Credit investigation fees

Interest relating to tax-exempt income

Interest to purchase or carry tax-exempt securities

Certain expenses treated as interest in connection with the short sale of tax-exempt securities

Interest paid to carry single-premium life insurance

Interest to purchase or carry certain straddle positions

Penalties

Premium on a convertible bond

Items You May Deduct As Deductible Home Mortgage Interest

Mortgage interest

Redeemable ground rents

"Points," if you are a borrower

Mortgage prepayment penalty

Home equity loan or line of credit interest

Note. Generally, you may fully deduct these items only if you pay them for a loan secured by your home. (Home improvement loans usually are not secured by your home and therefore the interest you pay on them is not fully deductible.) If the property is not your main or second home, then these items are personal interest items. You may deduct only 40% of the personal interest you paid in 1988.

Items You May Deduct As Personal Interest

Interest on a personal loan

Installment plan interest

Bank credit card plan interest

Finance charges, if separately stated

Revolving charge account interest

Unstated interest

Home improvement loan (unsecured) interest

Note. Only 40% of your personal interest payments are deductible in 1988.

Items You May Not Deduct

Some interest payments are not deductible. Certain expenses similar to interest also are not deductible.

Interest paid on a loan from a "Clifford" trust. If you, as the grantor of a "Clifford" trust, borrow funds from the trust, no part of the interest payments you make are deductible unless the loan is a genuine debt.

Interest to purchase or carry tax-exempt securities. You may not deduct interest on money you borrow to buy tax-exempt securities. See Publication 550.

Interest deducted in advance from a life insurance loan. If you are a cash method taxpayer, and you borrowed money on your life insurance policy, you may not deduct the interest on the loan in the following situations:

The insurance company deducted the interest in advance from the amount of the loan, or

You did not make interest payments when due and the insurance company added the interest due to the loan.

If you are an accrual method taxpayer, you may deduct the interest only when the liability to pay accrues (subject to the personal interest limits).

Example. You are a cash method taxpayer and you borrow $1,000 on your life insurance policy in 1988. The insurance company pays you $950 and keeps $50 as interest paid in advance. Your first interest payment is not due until 1989. You have no interest deduction for this loan for 1988.

Single-premium life insurance, endowment, or annuity contracts. You may not deduct interest on money you borrow to buy a single-premium life insurance, endowment, or annuity contract. This includes—

1) Policies on which you pay almost all the premiums within 4 years from the date of purchase, and
2) Policies on which you deposit an amount with the insurer to pay future premiums.

You may not deduct interest on a loan that is used to buy stock if the collateral on the loan is a single-premium annuity contract.

Insurance premiums paid in installments. Any extra charge included in insurance premiums because you pay the premiums on a semi-annual, quarterly, or monthly basis is not deductible as interest.

Systematic borrowing on insurance. If you plan to systematically borrow part or all of the increases in the cash value of a life insurance, endowment, or annuity contract then you may not deduct interest on these loans. Under these circumstances, you also may not deduct interest on the money you borrowed to buy the insurance policy.

Rental payments. If you live in a house before your final settlement, any payments you make for that period are rent, not interest, even if the settlement papers call them interest. You may not deduct these payments.

Amortization of bond premium. You may choose to amortize the premium you pay to buy taxable bonds. If you make this choice, you must reduce your basis in the bonds by a part of the premium each year over the life of the bond.

For bonds you acquired before October 23, 1986, deduct amortizable bond premiums on Schedule A (Form 1040) as a miscellaneous itemized deduction not subject to the 2% of adjusted gross income limit. For bonds you acquired after October 22, 1986, deduct amortizable bond premiums as an interest deduction on Schedule A (Form 1040).

If you choose not to amortize the bond premium, you treat it as part of your cost of the bond.

Caution: As this publication was being prepared for print, Congress was considering legislation that would allow you to deduct amortizable bond premiums directly from the interest income the bond earns. Generally, this rule applies to bonds you acquire after 1987. However, you may choose this method of deducting bond premiums on bonds you got after October 26, 1986.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Tax-exempt bonds. You must amortize the premium and reduce the basis of tax-exempt bonds. However, you may not deduct the amortized premium. See Publication 535, *Business Expenses*.

Penalties. You may not deduct fines and penalties for violations of law, regardless of their nature.

Mortgage Interest

Generally, mortgage interest is any interest you pay on a loan secured by your home. This includes: a mortgage, second mortgage, a line of credit, and a home equity loan. Provided the interest is deductible home mortgage interest, you may deduct all of it.

Limit on the Deduction of Mortgage Interest

The rules for deducting home mortgage interest have changed for 1988. In most cases, you will be able to deduct all of your home mortgage interest, even if your deduction was limited last year. The new rules apply to any loans secured by your main home, including first and second mortgages, home equity loans, and refinanced mortgages. Whether your home mortgage interest is deductible under the new rules depends on the date you took out the mortgage, the amount of the mortgage, and your use of its proceeds.

If all of your mortgages fit into one or more of the categories below, you can deduct ALL of the interest on those mortgages and report it on Schedule A (Form 1040). If one or more of your mortgages does not fit into any of the categories below, get Publication 936, *Limits on Home Mortgage Interest Deduction*, to figure the amount of interest you can deduct.

1) Mortgages you took out on your main home on or before October 13, 1987. These mortgages also include line-of-credit mortgages you had on October 13, 1987, and mortgages you had on October 13, 1987, that you refinanced after that date. But see *Special Rules* if you refinanced or borrowed additional amounts on a line-of-credit mortgage after October 13, 1987.

2) Mortgages you took out on your main home after October 13, 1987, to buy, build or improve your home, but only if these mortgages plus any mortgages described above totaled $1 million or less throughout 1988. The limit is $500,000 if married filing separately.

3) Mortgages you took out after October 13, 1987, on your main home, other than to buy, build or improve your home but only if these mortgages totaled $100,000 or less throughout 1988. The limit is $50,000 if married filing separately.

Note. You cannot deduct this interest if you use the proceeds of the mortgage to receive tax-free income.

Special Rules

Refinanced mortgage. If you had a mortgage on your home on October 13, 1987, and refinanced it after that date for no more than the balance of the existing mortgage, you can treat all of the new mortgage as a mortgage described in the first category above. But, if you refinanced it for more than the balance of the existing mortgage, only the part of the new mortgage equal to the amount you owed on the mortgage at the time you refinanced is treated as a mortgage described in the first category. The part of the new mortgage that is more than the balance of the existing mortgage is a mortgage described in the second or third categories above (or in the second and third categories above if a mixed-use mortgage, discussed later).

Line-of-credit mortgages. If you had a line-of-credit mortgage on your home on October 13, 1987, and you borrowed additional amounts on this line of credit after that date, the additional amounts you borrowed are treated as a mortgage taken out after October 13, 1987, and are subject to the rules under the second or third categories above (or in the second and third categories above if a mixed-use mortgage, discussed next).

Mixed-use mortgages. If you took out a new mortgage after October 13, 1987 (including refinancing for more than the amount you owed or borrowing additional amounts on a line-of-credit mortgage you had on October 13, 1987), for purposes described in both the second and third categories above, you have a mixed-use mortgage. The mortgage proceeds used to buy, build, or improve the home fit into the second category and the rest of the proceeds fit into the third category.

Example. You took out a mortgage on your home for $200,000 in 1980. You file as single for 1988. In March 1988, when the home had a fair market value of $400,000, and you owed $195,000 on the mortgage, you took out a home equity loan for $120,000. In 1988, you used $90,000 of the home equity loan proceeds for home improvements, and $30,000 for other purposes. You can deduct all of the interest on both mortgages. The first mortgage qualifies because it was taken out on or before October 13, 1987. The home equity loan qualifies under the dollar limits in the second and third categories described above. The part of the mortgage subject to the dollar limit in the second category above ($90,000) plus the first mortgage of $195,000 totaled less than $1 million. The part of the mortgage subject to the dollar limit in the third category above ($30,000) was less than $100,000.

Note. Additional limits apply if the total amount of all mortgages exceeds the fair market value of the home.

More than one home. If you had a main home and a second home, the dollar limits explained in the second and third categories above apply to the total mortgages on both homes.

Mortgage Interest Statement

If you paid mortgage interest of $600 or more during the year on any one mortgage, you may receive a Form 1098, *Mortgage Interest Statement*, or a similar statement. You will receive the statement if the payment is made to a person (including a financial institution and a cooperative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

The statement will show the total interest received during the year. However, it should not show points and other prepaid interest, seller payments on a "buy-down" mortgage, or HUD payments under section 235 of the National Housing Act.

You should receive the statement by January 31, 1989. The mortgage interest information will also be sent to the IRS. If the mortgage interest is fully deductible home mortgage interest, then it is deductible on line 9a, Schedule A (Form 1040), if paid to a financial institution, or line 9b, if paid to an individual. If the mortgage interest is not fully deductible home mortgage interest, then you may be able to deduct it as personal, investment, business, or passive activity interest, subject to the rules for those deductions.

If your home mortgage interest payments are more than the amount shown on the mortgage interest statement you will be able to fully deduct the amount of the interest that you ***actually paid.*** (However, you must meet the limits discussed earlier.) The interest must be for the tax year you are claiming the deduction.

For example, your mortgage payments are due on the first of the month. Therefore, if you make a January 1 mortgage payment in December of the year before, the interest on the January payment is for December (of the year before) and is deductible in the year paid. You must attach a statement to your tax return explaining this difference.

You may deduct only your share of the mortgage interest you paid. If your mortgage payments were subsidized by a government agency, do not deduct the amount paid for you.

If you and at least one other person (other than your spouse if you file a joint return) were liable for, and paid interest on a mortgage that was for your home and the other person received a Form 1098 showing the interest received during 1988, attach a statement to your return showing the name and address of the person who received the form. If the interest is fully deductible home mortgage interest, then in the far left margin, next to line 9a, Schedule A, write "see attached." If you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 you received, furnish the other borrowers with information about the proper distribution of the amounts shown on the form you received.

Points

The term "points" (paid by a borrower) is sometimes used to describe certain charges paid by a borrower. They are also called loan origination fees, maximum loan charges, or premium charges. If the payment of any of these charges is ***only*** for the use of money, it is interest.

These points are interest paid in advance and, generally, you may not deduct the full amount for points in the year paid. The prepaid interest paid as points must be spread over the life of the mortgage, and is considered as paid and is deductible over that period.

Exception. You may deduct the amount you pay as points in the year of payment if the loan is used to ***buy or improve your main home*** and is secured by that home.

This exception will only apply if—

1) The payment of points is an established business practice in the area where the loan was made,
2) The points paid did not exceed the number of points generally charged in this area, and
3) The points are paid with funds other than those obtained from your lender.

If you paid more points than generally paid in this area, your deduction is limited to the points generally charged. Any additional amount of points you paid is interest paid in advance and the deduction must be spread over the life of the mortgage.

The exception will not apply to points you pay on loans secured by your second home. For a second home, you may only deduct the points over the life of the loan.

Refinancing. Points you pay in refinancing a mortgage, regardless of how you arrange to pay them, are not deductible in full in the year you pay them unless they are paid in connection with the purchase or improvement of a home. This is true even if the new mortgage is secured by your main home.

For more information on refinancing, see Publication 545, *Interest Expense*.

Points charged for specific services by the lender for the borrower's account are not interest. Examples of fees for services not considered interest are the lender's appraisal fee, preparation costs for the mortgage note or deed of trust, settlement fees, and notary fees. Points charged for services for getting a Veterans Administration loan are not interest.

Expenses you pay in connection with a mortgage, such as commissions, abstract fees, and recording fees, are capital expenses. You may not deduct these expenses either as interest or as current business expenses. Add these to the basis of the property.

Example 1. Don Smith borrowed $48,000 to buy his $60,000 home. He paid the lender, in addition to interest at 13%, a loan processing fee of $1,440 (three points). None of the fee was for specific services. The charging of points was an established business practice in the area and the number of points was not more than that generally charged in the area. The $1,440 loan processing fee (points) is interest. Don may deduct it in the year of payment on line 10, Schedule A (Form 1040).

Example 2. Jan Green got a loan from a bank to buy her home. The loan was guaranteed by the Veterans Administration. Jan paid the bank a loan origination fee. The fee was 1% of the amount of the loan. It was charged in addition to the maximum rate of interest permitted. The 1% loan origination fee (one point) is not interest. Jan may not deduct it.

"Points" paid by a seller. The term "points" also is used to describe loan placement fees that the seller may have to pay to the lender to arrange financing for the buyer. The seller may ***not*** deduct these amounts as interest. But these charges are a selling expense that reduce the amount realized. See Chapter 17 for information on selling your home.

Special Rules

If you sell your home, you may deduct the interest paid up to, but not including, the date of sale.

Example. John and Peggy Harris bought a new home on May 4. They sold their old home on May 6. During the year they made deductible home mortgage interest payments of $122 on the old home and $2,864 on the new home. The settlement sheet for the sale of the old home showed $4 interest for the 5–day period in May up to, but not including, the date of sale. Their mortgage interest deduction for the year is $2,990 ($122 + $2,864 + $4).

Late payment charge on mortgage payment. You may fully deduct a late payment charge if it was not for a specific service performed by your mortgage holder and it was deductible home mortgage interest.

Mortgage interest credit. If you are the holder of a qualified mortgage credit certificate that provides financing for the acquisition, qualified rehabilitation, or qualified home improvement of your main home, you may be able to take a mortgage interest credit. This credit is figured on Form 8396, *Mortgage Interest Credit.* If you take this credit, you must reduce your deduction for interest on the loan amount covered by the certificate by the allowable credit amount.

Generally, to figure the allowable credit, multiply the amount of interest paid during the year on the loan amount covered by the certificate by the certificate credit rate (10% to 50%) shown on your certificate. If the credit rate is more than 20%, your credit is limited to $2,000. The mortgage interest credit is discussed in Chapter 35.

Example. The mortgage interest paid on the loan amount shown on your mortgage credit certificate is $3,900. Your certificate credit rate is 30%. You reduce your mortgage interest by $1,170 ($3,900 × 30%), your allowable credit, and deduct $2,730 ($3,900 − $1,170) on line 9a, Schedule A (Form 1040).

Minister's and military housing allowance. If you are a minister or member of the uniformed services and receive a housing allowance that you may exclude from income, you may nevertheless deduct all of the deductible interest on your home mortgage.

Graduated payment mortgages (GPM). GPMs under section 245 of the National Housing Act provide that monthly payments go up every year for a number of years and stay the same after that. During the early years, payments are less than the amount of interest owed on the loan. Unpaid interest is put off and added to the loan principal. Future interest is figured on the increased unpaid mortgage loan balance.

You may deduct the interest you actually paid during the year if you are a cash method taxpayer. For example, if the interest owed is $2,551 but your payment for the year is $2,517, you may deduct $2,517. Add $34 to the loan principal.

Mortgage assistance payments. If you qualify for mortgage assistance payments under section 235 of the National Housing Act, part or all of the interest on your mortgage may be paid for you. You may not deduct any interest that is paid for you. You do not include these payments in your income. However, these payments do not reduce other deductions, such as taxes.

Redeemable ground rents. If you make annual or periodic rental payments on a redeemable ground rent, you may deduct them as mortgage interest.

Payments made to buy the lessor's entire interest in the title are not ground rents. You may not deduct them. For more information, see Publication 545.

Nonredeemable ground rent. Payments on a nonredeemable ground rent are not interest. You may deduct them as rent if they are a business expense or if they are for rental property held to produce income.

Reverse mortgage loans. A reverse mortgage loan is a loan that is based on the value of your home and is secured by a mortgage on your home. The lending institution pays you the proceeds of the loan in installments over a period of months or years. The loan agreement may provide that interest will be added to the outstanding loan balance monthly as it accrues. If you are a cash method taxpayer, you deduct the interest on a reverse mortgage loan when you actually pay it, not when it is added to the outstanding loan balance.

Mortgage prepayment penalty. If you pay off your mortgage early, you may have to pay a penalty. You may deduct that penalty as deductible home mortgage interest if it qualifies. Otherwise, you may deduct it as personal interest.

Personal Interest

The following interest items are deductible as personal interest, if the loan is used for personal purposes.

Interest on a personal loan
Installment plan interest
Bank credit card plan interest
Finance charges, if separately stated
Unstated interest
Mortgage interest in excess of the limits discussed earlier, or on other than your main or second home and
Interest in connection with performing services as an employee.

Personal interest is any interest ***other than:***

Trade or business interest,
Investment interest,
Passive activity interest,
Interest on the deferral of certain estate taxes, and
Fully deductible home mortgage interest.

Note. Only 40% of your personal interest payments are deductible in 1988.

Limits on the Deduction of Personal Interest

You may only deduct a part of personal interest you paid. The amount you may deduct decreases each year until 1991. After 1990, you will not be allowed any deduction for personal interest.

The percentage of personal interest that is deductible for 1988 through 1991 is shown below.

Year	Deductible Percentage
1988	40%
1989	20%
1990	10%
1991	-0-

Example. In 1988, Marion paid personal interest on her credit card balance, personal loan, and car loan. The total she paid was $1,000. Marion was entitled to deduct 40% of this interest as an itemized deduction on her 1988 tax return.

The table below illustrates how much interest Marion could deduct if she makes the same interest payments in 1988 and later years.

Year	Interest Paid		Deductible Percentage	Amount Deductible
1988	$1,000	×	40% =	$400
1989	$1,000	×	20% =	$200
1990	$1,000	×	10% =	$100
1991	$1,000	×	0% =	-0-

All personal interest is subject to the phase-out regardless of when you obtained the loan. Therefore, interest you pay after 1986 on loans you obtained before 1987 will be subject to this phase-out.

Example. Jay obtained a five-year car loan in 1986. In 1988, Jay's interest payments on his car loan were $275, in 1989, $180, and in 1990, $110.

Although Jay obtained his loan before 1987, the deduction for any interest he paid on his car loan is limited as shown below:

Year	Interest Paid		Deductible Percentage	Amount Deductible
1988	$275	×	40% =	$110
1989	$180	×	20% =	$ 36
1990	$110	×	10% =	$ 11

If Jay made any car loan interest payments in 1991, he would not be able to deduct any of his interest payments.

Interest on income tax. Interest you pay on income taxes (whether Federal, State, or local) is personal interest. This includes interest on taxes from an S corporation (in which you are a shareholder), a partnership (in which you are a partner), and your trade or business. However, interest on income tax of a corporation in which you are a shareholder is not personal interest.

Personal Interest Items

The following items are personal interest and are partly deductible. See *Limits on the Deduction of Personal Interest,* earlier.

Installment Plan Interest

When you buy property on the installment plan (buying on time), you may deduct 40% of your interest payments if they are separately stated or if they can be determined and proved.

Credit card finance charges. You may only deduct 40% of the finance charges added to your monthly statements. Finance charges figured at an annual percentage rate and are based on the unpaid monthly balances.

Bank credit card. You may deduct 40% of the finance charges on your bank credit card account balance if no part of the charge is a service charge, loan fee, credit investigation fee, or similar charge.

One-time charges. You may deduct as personal interest 40% of a one-time charge for each cash, check, or overdraft advance added to your bank credit card account balance.

Retail installment contract finance charges. You may deduct 40% of the separately stated finance charges figured under an annual percentage rate shown in a retail installment contract. You also may deduct any fee you are charged for prepaying the contract.

Revolving charge account finance charges. When you buy personal property such as clothing, jewelry, furniture, or appliances, on the installment plan using a revolving charge account, there is usually a separate finance charge. You may deduct 40% of the total amount of these finance charges as interest.

Example. You bought a stove for $800 and charged it to your revolving charge account. If you pay the balance within 30 days after you are billed, there is no extra charge. If you make installment payments, you will be charged a monthly finance charge of 1½% on the unpaid balance. You may deduct 40% of your total finance charges as personal interest.

Unstated interest. If you make installment payments under a contract with a term of more than a year that has a sales price of more than $3,000 and includes no interest, or only a low stated interest, you may still be able to deduct as personal interest 40% of the amount referred to as unstated interest.

See Publication 537 for information on unstated interest.

Late payment charge by a public utility. You may deduct as personal interest 40% of the late payment charge you paid, if it was not for a specific service the public utility did for you.

Below-Market Interest Rate Loans

If you receive a below-market interest rate loan, you may be able to claim an interest expense deduction in excess of any interest that you may actually have paid. The lender would have to report that amount as interest income.

A ***below-market loan*** is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan is generally treated as an arm's-length transaction in which you, as the borrower, are deemed (1) to have received a loan in exchange for a note that requires the payment of interest at the applicable federal rate, and (2) to have received an additional payment. The additional payment is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction. You may have to report this payment as taxable income depending on its classification.

For these rules to apply to a below-market loan, two transactions are assumed to have taken place:

- A transfer of an amount of foregone interest from the lender to the borrower, and
- A retransfer of the foregone interest from the borrower to the lender.

Gift and demand loans. If you receive a below-market gift demand loan or other demand loan (one payable in full at any time upon the lender's demand), you are treated as receiving an additional payment (as a gift, dividend, etc.) equal to the foregone interest. You are treated as transferring the foregone interest to the lender and may, therefore, be entitled to deduct a part of that amount as interest expense. These transfers are deemed to occur annually, generally on December 31. Foregone interest for any period is the amount of interest that would be payable for that period if interest accrued at the applicable federal rate and was payable annually on December 31, over any interest payable on the loan for such period. The applicable federal rate is set by the Internal Revenue Service each month in a revenue ruling. Contact an IRS office for these rates.

Term loans. If you receive a below-market term loan (one that is not a demand loan), you are treated as receiving an additional lump-sum cash payment (as a gift, dividend, etc.) on the date the loan is made. The amount of this payment is the excess of the amount of the loan over the present value of all payments due under the loan. An amount equal to this excess is treated as original issue discount. Accordingly, the original issue discount rules of section 1272 of the Internal Revenue Code apply and you may be able to claim an interest expense deduction. Original issue discount is discussed in Chapter 8.

If you receive a ***gift term loan,*** you are treated as receiving an additional amount as determined using the rules for term loans. However, the amount of foregone interest treated as transferred by you to the lender is determined using the rules for demand loans, discussed earlier.

Loans subject to the rules. The rules for below-market loans apply to:

1) Gift loans
2) Compensation-related loans
3) Corporation-shareholder loans
4) Tax avoidance loans
5) Other below-market loans

Exceptions. The rules for below-market loans do not apply to:

1) Gift loans between individuals if:
    a) The total outstanding amount of loans between such individuals is $10,000 or less, and
    b) The loan is attributable to any purpose other than the purchase or carrying of income-producing assets; or
2) Compensation-related loans or corporation-shareholder loans if:
    a) The total outstanding amount of loans between you and the lender is $10,000 or less, and
    b) The avoidance of federal tax is not a main purpose of the loan.

Special rules for gift loans between individuals that do not exceed $100,000. Foregone interest on a gift loan may be treated as being transferred from you to the lender. The amount considered transferred is limited to the amount of your net investment income (for the year). Foregone interest on a gift loan ***will not be*** treated as transferred from you to the lender, if your net investment income is $1,000 or less (for the year).

For additional information on loans not subject to the below-market loan rules, see Publication 545.

Effective dates. These rules apply to term loans made after June 6, 1984, and to demand loans outstanding after that date.

For more information, see sections 7872 of the Internal Revenue Code and 1.7872–5T of the regulations.

Rule of 78's

For loans made before 1984, a loan agreement could provide that the interest was figured under the rule of 78's. The interest you pay on these loans is subject to the personal interest limits. The rule of 78's represented a purely mechanical formula for allocating interest among periods. The rule of 78's computation failed to reflect the true cost of borrowing.

The rule of 78's may only be used for a short-term consumer loan. To qualify as a short-term consumer loan, the loan must:

1) Be for no more than 5 years,
2) Not have a balloon payment at the end,
3) Be self-amortizing (that is, the number of level payments called for in the loan agreement must reduce the loan balance to zero), and
4) Require level payments at regular intervals at least yearly.

If you have been figuring your interest expense deduction on a short-term consumer loan under the rule of 78's method, you may continue to figure your deductions under that method for the rest of the life of the loan, or you may decide to change the way you report your interest expense deduction. If you decide to change your method of accounting for interest expense on a short-term consumer loan, you must follow the instructions in Revenue Procedure 84–30. A copy of this revenue procedure is available in many Internal Revenue Service offices. You will also need Form 3115, *Application for Change in Accounting Method.*

Loan that was not a short-term consumer loan. If the loan was not a short-term consumer loan, and you met certain conditions, you may have been able to figure and report your interest deduction using a simplified method. If you did not meet the conditions for the simplified method, you had to change the way you figured and reported your interest expense by following the instructions in Revenue Procedure 84–27 or Revenue Procedure 84–28, whichever applied. Copies of these revenue procedures are available in many Internal Revenue Service offices. You will also need Form 3115.

Prepayment of loan. If you prepay a loan, which was subject to the rule of 78's, for which you changed your method to reflect the true cost of borrowing, you may deduct, as personal interest, 40% of the difference between the final payment required under the rule of 78's method and the true cost. This amount is in addition to any amount you would otherwise be entitled to deduct as interest paid during the year.

Allocation of Interest

As discussed earlier in this chapter, the rules for deductibility of interest vary, depending on whether the interest is personal interest, home mortgage interest, business interest, or investment interest (including passive activity interest). If the proceeds of a loan are applied to mixed uses, an allocation must generally be made to determine the amount of interest for each category. However, interest that is fully deductible home mortgage interest is ***not*** allocated, regardless of the purpose for which you use the funds.

You allocate interest (other than fully deductible mortgage interest) on a loan in the same way as the loan itself is allocated. You do this by tracing disbursements of the debt to specific uses. For details on how to do this, see Publication 545.

Where to Deduct

You must file Form 1040 to deduct any interest expense on your tax return. Where you deduct your interest expense generally depends on how you use the loan proceeds.

Deduct fully deductible home mortgage interest you paid directly, or indirectly, to financial institutions on line 9a, Schedule A (Form 1040).

Deduct fully deductible home mortgage interest you paid to an individual on line 9b. List the person's name and address in the space provided.

Deduct points on a mortgage on line 10, Schedule A (Form 1040).

Deduct interest of a personal nature, such as interest you pay on car loans, on line 12, Schedule A (Form 1040). This includes mortgage interest that is not qualified home mortgage interest, or that exceeds the limits discussed earlier, and that is not a business or investment expense.

Interest charged on any unpaid amount of income tax you owe is personal interest, even if it relates to your trade or business.

Deduct investment interest, subject to certain limits discussed in Publication 550, on line 11, Schedule A (Form 1040).

Deduct interest on non-farm business loans on Schedule C (Form 1040).

Deduct interest on farm business loans on Schedule F (Form 1040).

Deduct interest on a loan for income-producing rental or royalty property that is not used in your business in Part I of Schedule E (Form 1040).

Example. You rent out part of your home and borrow money to make repairs. You may deduct only the interest payment for the rented part in Part I of Schedule E (Form 1040). Deduct the rest of the interest payment on Schedule A (Form 1040).

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26. Contributions

A charitable contribution is a contribution or gift to, or for the use of, a qualified organization. This chapter provides information about:

- Qualified organizations,
- Deductible and nondeductible contributions,
- Limits on deductibility,
- Recordkeeping, and
- Reporting your deduction.

Checklist of Contributions

Use the following lists for a ***quick check*** of the kinds of contributions that you may or may not deduct. More examples are found later in this chapter.

You May Deduct—

You may deduct contributions to:

- Churches, Salvation Army, Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts, Girl Scouts, Boys and Girls Club of America, etc.
- Veterans' groups.
- Nonprofit schools and hospitals.
- Federal, state, and local governments, if the gifts are solely for public purposes.
- Civil defense organizations.
- Public parks and recreation facilities.

You May Not Deduct—

You may not deduct as contributions:

- Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups.
- Cost of raffle, bingo, or lottery tickets.
- Tuition.
- Value of your time or services.
- Value of blood given to a blood bank.
- Donations to homeowners associations.
- Gifts to individuals.

Qualified Organizations

Any organization can tell you if it is a qualified organization. You may deduct a contribution you made to, or for the use of, the following qualified organizations.

A state, a U.S. possession (including Puerto Rico), a political subdivision of a state or possession, the United States, or the District of Columbia, if the contribution is made only for public purposes. An Indian tribal government and any of its subdivisions that are recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for purposes of the charitable contributions deduction.

A community chest, corporation, trust, fund, or foundation organized or created in, or under the laws of, the United States, any state, the District of Columbia, or any possession of the United States. The organization must be organized and operated only for charitable, religious, educational, scientific, or literary purposes. It may also be for the prevention of cruelty to children or animals. Certain organizations that foster national or international amateur sports competition are also included.

War veterans organizations, including posts, auxiliaries, trusts, or foundations organized in the United States or its possessions.

Domestic fraternal societies operating under the lodge system, if the contribution is to be used only for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Nonprofit cemetery companies, if the contribution can be used only for the perpetual care of the cemetery as a whole, and not for a particular lot or mausoleum crypt.

Examples of qualified organizations. Qualified organizations include:

- Nonprofit volunteer fire companies.
- Civil defense organizations.
- Public parks and recreation facilities.
- Nonprofit hospitals and medical research organizations.
- Churches or other religious organizations.
- Most nonprofit educational organizations, including day care centers if substantially all the child care provided is to enable individuals (the parents) to be gainfully employed and the services are available to the general public. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution, as explained later under *Nondeductible Contributions.*
- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs.
- Most nonprofit charitable organizations, such as Salvation Army, Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts, Girl Scouts, Boys and Girls Club of America, etc.

Deductible Contributions

Generally, you may deduct your contributions of money or property that you make to, or for the use of, qualified organizations. If you give property to a qualified organization, you generally may deduct the fair market value of the property at the time of the contribution. See *Gifts of Property,* later in this chapter.

Your deduction for charitable contributions is limited to 50% of your adjusted gross income, but in some cases 20% and 30% limits may apply. See *Limit on Deductions,* later.

Benefits Received

If you contribute to a charitable organization and also receive a benefit from it, you may deduct only the amount that is more than the value of the benefit you receive. If you pay more than fair market value to a qualified organization for merchandise, goods, or services, the amount you pay that is more than the value of the item may be a charitable contribution.

Example 1. You pay $20 for a box lunch at a church picnic. All of the proceeds of the picnic go to the church. If the lunch, plus any entertainment or other services provided, has a fair market value of $6, the excess paid, $14, is a contribution to the church.

Example 2. At a fund-raising auction conducted by a charity, you pay $600 for a week's occupancy of a house at the beach. The amount you pay is no more than the fair rental value. You have not made a deductible charitable contribution.

Example 3. You pay $300 annually for membership in an athletic scholarship program maintained by a university (a qualified organization). The only benefit of membership is that you are entitled to purchase one season ticket to the university's home football games in a designated area of the stadium, for a stated price of $120. Because the games are regularly sold out well in advance, tickets to the home games would not be readily available to you unless you make the payment to the program. The university does not provide any information about the fair market value of the right to purchase a season ticket in the designated area.

Because the tickets to the games would not otherwise be readily available to you, the right to purchase a season ticket in a designated area of the stadium is a substantial benefit allowed to you. The $300 membership fee is presumed to reflect the value of the benefit you receive. Unless you can establish that $300 is more than the value of the benefit you receive, no part of the $300 payment is a charitable contribution.

Example 4. Assume the same facts as in Example 3, except that, although tickets are offered to members before they go on sale to the public, the seating in a designated area in the stadium is reasonably comparable to that which you would be able to obtain even if you do not make a payment to the program.

Although you receive the benefit of obtaining a ticket early and of sitting with other program members, the benefit is not substantial. In this case, the entire $300 is a charitable contribution.

Caution. As this publication was being prepared for print, Congress was considering legislation that would allow a deduction for 80% of the payments described in *Example 3* and *Example 4,* regardless of whether tickets to the games would be readily available without such payments. This rule would not apply to any payment for tickets. If enacted, the change would be effective for payments made in tax years beginning after 1983.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Benefit performances, etc. If you pay more than fair market value to a qualified organization for charity balls, banquets, shows, sporting events, etc., you may deduct only the amount that is more than the value of the privileges or other benefits you receive.

If there is an established charge for the event, that charge will determine the value of your benefit. If there is no set charge, only that part of your payment that is more than the reasonable value of your benefit is a gift. Whether you use the tickets or other privileges has no effect on the amount you may deduct.

The fact that the amount shown on a ticket or other evidence of payment indicates it is a "contribution" does not necessarily mean you may deduct the entire amount. If the ticket shows the price of admission and the amount of the gift, you can deduct the gift amount.

Example. You pay $20 to see a special showing of a movie for the benefit of a qualified organization. Printed on the ticket is "Contribution—$20." If the regular price for the movie is $4, your contribution is $16.

Dues, fees, or assessments are deductible if you pay them to qualified organizations. However, you may deduct only the amount that is more than the value of the benefits you receive. You may not deduct dues, fees, or assessments paid to country clubs and other social organizations.

Student Living With You

If you pay the costs of a student who lives in your home, you may deduct up to $50 a school month of the amount you pay. The student may be foreign or American and must be someone who is not your dependent or relative. The student must be a member of your household under a written agreement between you and a qualified organization. The purpose of the agreement must be to provide educational opportunities for the student.

You may deduct up to $50 of your expenses for each full calendar month of your tax year during which the student is:

1) A member of your household, and
2) A full-time student in the 12th or lower grade at a school located in the United States.

A period of 15 or more days in a month is a full calendar month for this purpose.

You may not deduct the costs of a foreign student living in your home under a mutual exchange program whereby your child will live with a family in a foreign country.

For additional information about deducting the costs of a student living with you, see Publication 526.

Out-of-Pocket Expenses

You may deduct some amounts you pay in giving services to a charitable organization. However, you may not deduct the value of your time or services.

Conventions. If you are a chosen representative attending a convention of a qualified organization, you may deduct actual unreimbursed expenses for travel and transportation, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention. However, see *Travel expenses*, later.

You may not deduct personal expenses for sightseeing, fishing parties, theater tickets, or nightclubs. You also may not deduct travel, meals and lodging, and other expenses for your spouse or children.

You may not deduct your expenses in attending a church convention if you go only as a member of your church rather than as a chosen representative. You may deduct unreimbursed expenses that are directly connected with giving services for your church during the convention.

Cost and upkeep of uniforms. You may deduct the cost and upkeep of uniforms that you must wear while performing donated services for a charitable organization if they are not suitable for everyday use.

Foster parents. If you are a foster parent (foster care provider) and have no profit motive in providing foster care, you may deduct expenses you pay that exceed any nontaxable payments you receive to provide foster care for individuals placed in your home by a charitable organization. The expenses must be amounts spent to provide support for the individual. For more information about payments received as a foster care provider, see Chapter 13.

Car expenses. You may deduct unreimbursed out-of-pocket expenses, such as the cost of gas and oil, that are directly related to the use of your car in giving services to a charitable organization. You may not deduct any part of general repair and maintenance expenses, depreciation, or insurance.

If you do not want to deduct your actual expenses, you may use a standard rate of ***12 cents a mile*** to figure your contribution.

You may deduct parking fees and tolls, whether you use your actual expenses or the standard rate.

Travel expenses. You may deduct your transportation and other travel expenses while you are away from home performing services for a charitable organization. Deductible travel expenses include:

- Air, rail, and bus transportation,
- Out-of-pocket expenses for your car,
- Taxi fares or other costs of transportation between the airport or station and your hotel,
- Lodging costs, and
- The cost of meals.

For additional information about travel expenses, see Chapter 19.

Daily allowance (per diem). If you provide services for a charitable organization and receive a daily allowance to cover reasonable travel expenses, including meals and lodging while away from home overnight, include in income the amount that is more than your actual travel expenses. You may deduct your necessary travel expenses that are more than the allowance.

Travel for pleasure, recreation, or vacation. You may claim a charitable contribution deduction for travel expenses while you are away from home performing services for a charitable organization only if there is no significant element of personal pleasure, recreation, or vacation in such travel. This applies whether you pay the expenses directly, or indirectly through reimbursement by the charitable organization. An arrangement whereby you make a payment to the charitable organization and the organization pays for your travel expenses is treated as a reimbursement.

The deduction will not be denied simply because you enjoy providing services to the charitable organization.

Example 1. You are a troop leader for a tax-exempt youth group and take the group on a camping trip. You may qualify to take a charitable deduction for your own travel expenses if you are on duty in a genuine and substantial sense throughout the trip, even though you enjoyed the trip. However, if you have only nominal duties relating to the performance of services for the charity, or for significant portions of the trip you are not required to render services, you may not take a charitable deduction for travel expenses.

Example 2. You sail from one island to another and spend eight hours a day counting whales and other forms of marine life. The project is sponsored by a charitable organization. In most circumstances, no charitable deduction is allowed for the expenses you incur.

Example 3. You work on an archaeological excavation sponsored by a charitable organization for several hours each morning. The rest of the day is free for recreation and sightseeing. No charitable deduction is allowed even if you work very hard during the morning hours.

Example 4. You spend the entire day attending a charitable organization's regional meeting. In the evening you go to the theater. You may qualify to claim your travel expenses as charitable contributions.

When Deductible

To deduct your contributions, you must make them in cash or other property before the close of your tax year. This applies whether you use the cash or accrual method of accounting.

Usually, you make a contribution at the time of its unconditional delivery. For example, a check that you mail to a charity is considered delivered on the date you mail it. If you use a pay-by-phone account, the date reported on the statement of the financial institution showing when payment was made is the date of payment.

The gift to a charity of a properly endorsed stock certificate is completed on the date of mailing or other delivery to the charity or to the charity's agent. However, if you give a stock certificate to your agent or to the issuing corporation for transfer to the name of the charity, your gift is not completed until the date the stock is transferred on the books of the corporation.

If you issue and deliver a promissory note to a charitable organization as a contribution, it is not a contribution until you make the note payments. Similarly, if you grant an option to buy real property at a bargain price to a charitable organization, no deduction is allowed until the organization exercises the option.

If you make a contribution with borrowed funds, a deduction is allowed in the year you make the contribution, regardless of when you repay the loan. Contributions charged on your bank credit card are deductible in the year you make the charge.

Nondeductible Contributions

This section of the chapter provides information about a number of contributions which have been held not to be deductible by the Internal Revenue Service. For more information about the deductibility of your contributions, see *Qualified Organizations* and *Deductible Contributions*, earlier in this chapter.

Nonqualified organizations. Some organizations are not qualified to receive tax-deductible contributions. Contributions to the following organizations, for example, are not deductible:

- Chambers of commerce and other business leagues or organizations,
- Civic leagues,
- Communist organizations,
- Country clubs and other social clubs,
- Homeowners associations,
- International organizations, and
- Political organizations and candidates.

Appraisal fees that you pay to find the fair market value of donated property are not deductible as contributions. You may claim them, subject to the 2% limit, as miscellaneous deductions on Schedule A (Form 1040). See Chapter 30.

Blood donated to the Red Cross or to other blood banks is not deductible.

Contributions to a fraternal society are not deductible if they are used to pay sickness or burial expenses of members.

Contributions made directly to a foreign organization are not deductible. However, you may deduct contributions to a U.S. organization that transfers funds to a charitable foreign organization if the U.S. organization controls the use of the funds, or if the foreign organization is only an administrative arm of the U.S. organization.

Exception. Under an income tax treaty with Canada you may be able to deduct contributions to certain Canadian charitable organizations. See Publication 597, *Information on the United States-Canada Income Tax Treaty,* for information on how to figure your deduction.

Contributions used to influence legislation are not deductible. Even if an organization is a qualified organization, no deduction is allowed for contributions to the organization that are earmarked for use in, or in connection with, attempting to influence the general public on legislative matters, elections, or referenda.

Direct contributions to needy or worthy individuals are not deductible. The contributions must be made to or for the use of a qualified organization and not earmarked by you for the use of a specific person.

Donation of use of property. If you permit a charitable organization to use your property, you may not deduct the value of its use. For example, you may not deduct the value of the use of your land by a church for a picnic. However, see *Partial interest in property* in Publication 526 for more information.

Dues to labor unions are not charitable contributions. You may deduct them as a miscellaneous expense, subject to the 2% limit, on Schedule A (Form 1040). See Chapter 30.

Payments to a hospital for care of particular patients or for services provided to such patients are not deductible as contributions, even if the hospital is operated by a city, a state, or a qualified organization.

Pre-adoption expenses of keeping a child in your home before the child is adopted may not be deducted as a contribution. However, you may be able to claim an exemption for the child. See Chapter 3.

Raffles, bingo, etc. You may not deduct as charitable contributions amounts you pay to a charitable organization to buy raffle tickets or to play bingo or other games of chance. They are gambling losses, which may be deducted as an itemized deduction only to the extent of gambling winnings. See Chapter 30.

Sustainer's gift to retirement home. You may not deduct the sustainer's gift you pay when being admitted to a retirement home operated by a qualified organization. Generally, such a gift entitles you to the benefit of occupying a certain type of apartment.

Tuition, or amounts you pay instead of tuition, are not deductible as contributions, even if they are paid for children who attend parochial schools or qualifying nonprofit day care centers. A fixed amount, designated as a ***donation,*** that is required to be paid to a private school in addition to the tuition fee as a condition of enrollment is not deductible.

The value of your time or services that you contribute to a qualified organization is not deductible.

Gifts of Property

If you donate property to a qualified organization, you generally may deduct the fair market value of the property at the time of the contribution. However, if the property has increased in value, you may have to make some adjustments. See *Giving Property That Has Increased in Value,* later.

For information about the records you must keep and the information you must furnish with your return if you donate property, see *Recordkeeping and How to Report,* later.

Partial interest in property. Generally, no deduction is allowed for a charitable contribution, not made by a transfer in trust, of less than your entire interest in property. For exceptions, see Publication 526. A contribution of the right to use property is a contribution of less than your entire interest in that property and is not deductible. For information about the valuation of a gift of a partial interest in property, see Publication 561.

Future interests in tangible personal property. You may deduct the value of a charitable contribution of a future interest in tangible personal property only after all intervening interests in and rights to the actual possession or enjoyment of the property have either expired or been turned over to someone other than yourself or a related party or a related organization.

A future interest is any interest that is to begin at some future time, regardless of whether it is designated as a future interest under state law.

Determining Fair Market Value

Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the necessary facts. For more information see Publication 561, *Determining the Value of Donated Property.*

Used clothing and household goods. Generally, the fair market value of used clothing and household goods is far less than its original cost.

For used clothing, you should claim as the value the price that buyers of used items actually pay in used clothing stores, such as consignment or thrift shops.

See Publication 561 for information on the valuation of household goods, such as furniture, appliances, and linens.

Cars, boats, and aircraft. If you donate a car, boat, or aircraft, its fair market value must be determined.

Certain commercial firms and trade organizations publish monthly or seasonal guides, for different regions of the country, containing complete dealer sale prices or dealer-average-prices for recent model years. These guides also provide estimates for adjusting for unusual equipment, unusual mileage, and physical condition. The prices are not "official" and these publications are not considered an appraisal of any specific donated property. But they do provide clues for making an appraisal and suggest relative prices for comparison with current sales and offerings in your area.

These publications are sometimes available from the loan officer at a bank, credit union, or finance company.

Except for inexpensive small boats, the valuation of boats should be based on an appraisal by a marine surveyor because the physical condition is so critical to the value.

Example. You donate your car to a local high school for use by their students studying automobile repair. Your credit union told you that the "blue book" value of the car is $1,600. However, your car needs extensive repairs and, after some checking, you find that you would not be able to sell it for more than $750. You may deduct $750, the ***true*** fair market value of the car, as a charitable contribution.

Giving Property That Has Increased in Value

If you donate property with a fair market value that is more than your basis in it, you may have to reduce the fair market value by the amount of appreciation (increase in value) when you figure your deduction.

Ordinary income property. If the donated property would have resulted in ordinary income or short-term capital gain if it had been sold at its fair market value on the date it was contributed, your deduction is its fair market value minus the amount that would be ordinary income or short-term capital gain. Generally, this rule limits the deduction to your basis in the property.

Example. You donate stock that you held for 5 months to your church. The value of the stock is $1,000, but you paid only $800 (your basis). Because the $200 of appreciation would be short-term capital gain if you sold the stock, your deduction is limited to $800 (fair market value less the appreciation).

Capital gain property. You usually may deduct a gift of capital gain property at its fair market value. Capital gain property is property that would have resulted in long-term capital gain if it had been sold at its fair market value on the date it was contributed. However, you must reduce the fair market value by any increase in value, in some cases.

For more information on donated appreciated property, see Publication 526, *Charitable Contributions.*

Limit on Deductions

If your total contributions for the year are 20% or less of your adjusted gross income (line 32, Form 1040), they are fully deductible (provided they otherwise qualify) and it is not necessary to figure whether the limits discussed here apply.

If your contributions are more than 20% of your adjusted gross income, the amount of your deduction may be limited to either 20%, 30%, or 50% of your adjusted gross income, depending on the type of property you give and the type of organization you give it to. You may not deduct contributions of more than 50% of your adjusted gross income for the year. Adjusted gross income is not reduced by net operating loss carrybacks due to losses you have in later tax years.

The 50% limit applies to gifts (other than capital gain property deducted at fair market value) ***to*** organizations listed later under *50% limit organizations.*

The 30% limit applies to:

- Gifts ***for the use of*** any organization, and
- Gifts (other than capital gain property) to all qualified organizations other than 50% limit organizations. This includes gifts to veterans organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.

A special 30% limit applies to gifts of capital gain property (if deducted at fair market value) to 50% limit organizations (but see the rules for electing the 50% limit for capital gain property under *How to Figure Your Deduction,* in Publication 526).

The 20% limit applies to gifts of capital gain property to all qualified organizations other than 50% limit organizations.

50% limit organizations. The following are 50% limit organizations:

1) All public charities,
2) All private operating foundations,
3) Private nonoperating foundations that make qualifying distributions of 100% of contributions within 2½ months following the year they receive the contribution, and
4) Certain private foundations whose contributions are pooled in a common fund, the income and principal of which are paid to public charities.

The organization will be able to tell you if the contributions you make to it qualify for the 50% limit.

If you have contributed amounts that are subject to a 20% or a 30% limit, see Publication 526 for more information.

Carryovers. You may carry over your contributions that you are not able to deduct in the current year because they exceed your adjusted gross income limit. You may deduct the excess in each of the next 5 years until it is used up, but not beyond that time. For information on carryovers, see Publication 526.

Recordkeeping and How to Report

You are required to keep records to prove the amount of the cash and noncash contributions you make during the year. The kind of records you must keep depends on the amount of your contributions and whether they are cash or noncash contributions.

Cash contributions. If you make a charitable contribution of money, you must keep one of the following for each contribution you make:

1) A cancelled check,
2) A receipt (or a letter or other written communication) from the charitable organization showing the name of the organization, the date of the contribution, and the amount of the contribution, or
3) Other reliable written records that include the information described in (2). Records may be considered reliable if they are of a contemporaneous nature, if you regularly keep records, or if, in the case of small donations, you have items such as buttons, tokens, or emblems that are given to contributors.

Form 1040. Enter all of your cash contributions, including out-of-pocket expenses, on line 14, Schedule A (Form 1040). If you gave $3,000 or more to any one organization, enter the name of each such organization and the amount you gave.

Noncash contributions. The records you must keep and the forms you must file depend on whether your deductions for contributions of property other than money total:

1) $500 or less,
2) Over $500 but not more than $5,000, or
3) Over $5,000.

Deductions of $500 or less. If you make a noncash contribution, you must get and keep a receipt from the charitable organization showing:

1) The name of the charitable organization,
2) The date and location of the charitable contribution, and
3) A reasonably detailed description of the property.

A letter or other written communication from the charitable organization acknowledging receipt of the contribution and containing the information in (1), (2), and (3) will serve as a receipt. You are not required to have a receipt where it is impractical to get one. In all cases, you must keep reliable written records for each item of donated property.

Your written records must include the following:

1) The name and address of the organization that you contributed to.
2) The date and location of the contribution.
3) A reasonably detailed description of the property. For securities, give the name of the issuer, the type of security, and whether or not it is regularly traded on a stock exchange or in an over-the-counter market.
4) The fair market value of the property at the time of the contribution, and how you figured the fair market value. If it was determined by appraisal, keep a signed copy of the appraisal.
5) The cost or other basis of the property if you must reduce its fair market value by appreciation, the amount of the reduction, and how you figured it. If you choose the 50% limit instead of the special 30% limit on certain capital gain property, you must keep a record showing the years for which you made the choice, contributions for the current year, and carryovers from preceding years to which the choice applies. See *How to Figure Your Deduction* in Publication 526 for information on how to make the capital gain property election.
6) The amount you claim as a deduction for the tax year as a result of the contribution. If you contribute less than your entire interest in the property during the tax year, you must show the amount you claimed as a deduction in any earlier years for contributions of other interests in this property. You must also include the name and address of each organization to which you contributed the other interests, the place where any such tangible property is located or kept, and the name of the person who has possession of the property, if it is someone other than the organization to which you contributed.
7) The terms of any conditions attached to the gift of property.
8) If the gift was a "qualified conservation contribution," the fair market value of the underlying property before and after the gift, the type of legal interest donated, and the conservation purpose furthered by the gift. See *Qualified conservation contribution* in Publication 561 for more information.

Deductions over $500. You are required to give additional information if you claim a deduction over $500 for noncash charitable contributions. In addition, you must file Form 8283, *Noncash Charitable Contributions.* See Publication 526 for more information.

27. Nonbusiness Casualty and Theft Losses

As a result of hurricanes, earthquakes, tornadoes, fires, vandalism, car accidents, floods, and similar events, many people suffer damage to their property. When property is damaged or destroyed by an event like this, it is called a casualty. The loss you have because of a casualty may be deductible on your federal income tax return. If your property is stolen, you may also have a deductible theft loss. You must file Form 1040 and itemize your deductions on Schedule A (Form 1040) to be able to claim a casualty or theft loss to nonbusiness property. You cannot claim these losses if you file Form 1040A or Form 1040EZ.

You must reduce the amount of each casualty or theft loss on nonbusiness property by $100. You must further reduce the total of your casualty and theft losses for the year on nonbusiness property by 10% of your adjusted gross income. If these amounts are more than your losses, you do not have a casualty or theft loss deduction.

This chapter explains how and when to deduct a nonbusiness loss on your return. For information on how to treat a loss to business or income-producing property, including rental property, see Publication 549, *Condemnations and Business Casualties and Thefts.*

Publication 584, *Nonbusiness Disaster, Casualty, and Theft Loss Workbook,* is also available to help you make a list of your damaged belongings and figure the amount of your loss. This publication is also helpful to have because it can serve as an inventory of your personal belongings.

Condemnations. You may have a gain or loss when your property is condemned or disposed of under the threat of condemnation and you receive other property or money in payment. Condemnation is the process by which private property is legally taken, without the owner's consent, for public use by the federal government, a state government, or a political subdivision in exchange for a reasonable amount of money or property. For information on how to figure a gain or loss from a condemnation, see Publication 549.

Casualty

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. A ***sudden*** event is one that is swift, not gradual or progressive. An ***unexpected*** event is one that is ordinarily unanticipated and one that you do not intend. An ***unusual*** event is one that is not a day-to-day occurrence and one that is not typical of the activity in which you were engaged.

A casualty may also include a government ordered demolition or relocation of a home that is unsafe to use because of a disaster. For more information, see *Disaster Area Losses* in Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*

Casualty losses. Deductible casualty losses may result from a number of different causes, including—

Earthquakes

Hurricanes

Tornadoes

Floods

Storms

Volcanic eruptions

Shipwrecks

Mine cave-ins

Sonic boom

Vandalism

Fires. However, if you set the fire, you cannot deduct the resulting loss.

Smog, if it is an unusual event. For example, if a severe, sudden, and unexpected concentration of chemical fumes in the air damages the paint on your house, your loss is a casualty loss that may be deductible.

Loss of deposits in an insolvent or bankrupt financial institution. If you had money in a bank, credit union, or other financial institution that became insolvent or bankrupt, you may be able to choose to deduct your lost deposits as a casualty loss instead of later deducting a nonbusiness bad debt. However, you cannot make this choice if you are a 1% or more owner, an officer, or a relative of a 1% or more owner or of an officer of the financial institution.

Car accidents. However, the loss from an accident to your car is not a casualty loss if your willful negligence or willful act caused the accident, or if it was caused by the willful act or willful negligence of someone acting for you.

Other accidents. However, a loss due to the accidental breakage of articles such as glassware or china under normal conditions is not a casualty loss. Neither is a loss due to damage done by a family pet.

Nondeductible losses. There is no casualty loss deduction if the damage or destruction is caused by—

Termites or moths.

Disease. The damage or destruction of trees, shrubs, or other plants by a fungus, disease, insects, worms, or similar pests is not a deductible casualty loss. However, a sudden, unexpected, or unusual infestation by beetles or other insects may result in a casualty loss. If trees and shrubs are damaged by a storm, flood, or fire, the loss is a casualty.

Progressive deterioration. If a steadily operating cause or a normal process damages your property, it is not considered a casualty. Thus, the steady weakening of a building due to normal wind and weather conditions is not a casualty. The rust and water damage to rugs and drapes caused by the bursting of a water heater qualifies as a casualty, but the deterioration and damage to the water heater itself does not qualify.

Drought. When drought causes damage through progressive deterioration, it is not a sudden event.

Theft

A theft is the unlawful taking and removing of money or property with the intent to deprive the owner of it. It includes, but is not limited to, larceny, robbery, and embezzlement. If money or property is taken as the result of extortion, kidnapping, threats, or blackmail, it may also be a theft. You need only to show that the taking of your property was illegal under the law of the state where it occurred, and that it was done with criminal intent.

Mislaid or lost property. The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property may qualify as a casualty, if it results from an identifiable event that is sudden, unexpected, and unusual in nature.

Example. A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Proof of Loss

To take a deduction for a casualty or theft loss, you must be able to show that there was actually a casualty or theft, and you must be able to support the amount you take as a deduction.

For a ***casualty*** loss, you should be able to show:

- The type of casualty (car accident, fire, storm, etc.) and when it occurred,
- That your loss was the direct result of the casualty, and
- That you were the owner of the property, or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.

For a ***theft*** loss, you should be able to show:

- When you discovered that your property was missing,
- That your property was actually stolen, and
- That you were the owner of the property.

Amount of Loss

A casualty or theft loss is generally the lesser of the following two amounts:

1) The decrease in the fair market value of the property as a result of the casualty or theft, or
2) Your adjusted basis in the property before the casualty or theft.

The decrease in fair market value is the difference between the property's value immediately before the casualty or theft and its value immediately afterwards.

Fair market value is defined in Chapter 16. Basis is discussed in Chapter 15.

Adjusted basis. Adjusted basis is your basis (usually cost) increased or decreased by various events, such as improvements and other casualty losses.

Theft. The fair market value of property immediately after a theft is considered to be zero, since you no longer have the property. A theft loss is either the full fair market value of the stolen property or its adjusted basis, whichever is less.

Example. Several years ago, you purchased silver dollars at face value for $150. This is your adjusted basis in the property. Your silver dollars were stolen during 1988. The fair market value of the coins was $1,000 when they were stolen. However, your theft loss is $150.

Recovered property. If you get your stolen property back, your loss is measured like a casualty loss from vandalism. That is, you must consider the actual fair market value of the property when you get it back. Your loss is the decrease in the fair market value of the property from the time it was stolen until the time it is recovered or your adjusted basis in the property before the theft, whichever is less.

Leased property. If you are liable for casualty damage to property you lease from someone else, your loss is the amount you must pay to repair the property.

Rental property. If property you rent to others is completely destroyed, or completely lost because of a casualty or theft, your loss is your adjusted basis in the property, minus any salvage value and any insurance or other reimbursement you receive or expect to receive. The decrease in fair market value is not considered. See Publication 549.

Loss on deposits with an insolvent or bankrupt financial institution. The amount of the estimated loss that you may choose to deduct as a casualty loss is the difference between your deposit and the amount you reasonably expect to receive from the institution. Also see *Loss on deposits,* later under *When to Deduct a Loss.*

Decrease in fair market value. To figure the decrease in fair market value because of a casualty or theft, you must make a determination of the actual price you could have sold your property for immediately before and after the loss. An appraisal is the best way to make this determination.

Items not to be considered. Generally you should not consider the following items when attempting to establish the fair market value of your property.

Sentimental value. Do not consider sentimental value when determining the amount of your loss. If a family portrait, heirloom, or keepsake is damaged, destroyed, or stolen, you must base your loss only on its actual market value, not on any sentimental value.

General decline in market value. A decrease in the value of your property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not a casualty loss. You have such a loss only for actual casualty damage to your property.

The cost of protection. The cost of protecting your property against a casualty or theft is not a casualty or theft loss. For example, you cannot deduct what you spend on insurance or to board up your house against a storm. Expenses like these are only deductible by businesses as business expenses.

If you make a permanent improvement to your property to protect it against a casualty or theft, the cost should be added to your basis in the property. An example would be the cost of a dike to prevent flooding.

Related expenses. The incidental expenses you have due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of your casualty or theft loss.

Repair and replacement costs. The cost of repairing damaged property or of replacing stolen or destroyed property is not part of a casualty or theft loss. Neither is the cost of cleaning up after a casualty.

Example. You bought a new chair 4 years ago for $300. In April a fire completely destroyed the chair. You estimate that it would cost $500 to replace it. If you had sold the chair before the fire, you estimate that you could have gotten only $100 for it because it was 4 years old. Therefore, your loss is $100, the fair market value of the chair before the fire. It is not $500, the replacement value.

Indication of decrease in fair market value. You may use the cost of cleaning up or of making repairs after a casualty as a measure of the decrease in fair market value if:

1) The repairs are necessary to bring the property back to its condition before the casualty,
2) The amount spent for repairs is not excessive,
3) The repairs do no more than take care of the damage, and
4) The value of the property after the repairs is not, as a result of the repairs, more than the value of the property before the casualty.

Restoration of landscaping. The cost of restoring landscaping to its original condition after a casualty may be an indication of the decrease in fair market value. You may be able to measure your loss by what you spend on the following:

- Removing destroyed or damaged trees and shrubs, minus any salvage you receive,
- Pruning and other measures taken to preserve damaged trees and shrubs, and
- Replanting necessary to restore the property to its approximate value before the casualty.

Sources of Information. It is often difficult to value your property before and after the casualty or theft. The following sources will be helpful in establishing these values.

Photographs. Photographs taken after a casualty will be helpful in establishing the condition and value of the property after it was damaged.

The costs of photographs obtained for this purpose are not a part of the loss, but can be claimed as a miscellaneous deduction on line 21, Schedule A (Form 1040). The cost of the photographs is an expense of determining your tax liability.

Cars. Books issued by various automobile organizations may be useful in figuring the value of your car, if your car is listed in the books. You can use the books' retail values and modify them by such factors as mileage and the condition of your car to figure its value. The prices are not "official," but they may be useful in determining value and to suggest relative prices for comparison with current sales and offerings in your area. If your car is not listed in the books, you determine its value from other sources. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

Appraisals. The difference between the fair market value of the property immediately before a casualty or theft and immediately afterwards should be determined by a competent appraisal. The appraisal must recognize the effects of any general market decline that may occur along with the casualty so that any deduction is limited to the actual loss resulting from damage to the property.

The appraisal should be made by an experienced and reliable appraiser. Several factors are important in evaluating the accuracy of an appraisal:

1) The appraiser's familiarity with your property before and after the casualty or theft.
2) The appraiser's knowledge of sales of comparable property.
3) The appraiser's knowledge of conditions in the area of the casualty.
4) The appraiser's method of making the appraisal.

Appraisal fees. You may deduct your appraisal fees as a miscellaneous deduction on Schedule A (Form 1040) to the extent that your total miscellaneous deductions exceed 2% of your adjusted gross income. The appraisal fee is an expense of determining your tax liability. It is not a part of the casualty loss.

Records. It is important that you have records that will prove your deduction. If you do not have the actual records to support your deduction, you may use other satisfactory evidence that is sufficient to establish your deduction.

Insurance and Other Reimbursements

After you have figured the amount of your casualty or theft loss, you must figure how much of the loss you can deduct.

If your property is covered by insurance, you should file a timely insurance claim for reimbursement of a loss. Otherwise, you cannot deduct any part of this loss as a casualty or theft loss. However, that portion of the loss that is not covered by insurance, for example, a deductible, is not subject to this rule. Therefore, if you have a car insurance policy with a $500 deductible, the first $500 of an auto collision is not covered by insurance and would be deductible (subject to the $100 and 10% rules discussed later) even if you do not file an insurance claim.

If you receive insurance or another type of reimbursement for your loss, you must subtract the reimbursement from the amount of the loss when you figure your deduction. That is, you are not allowed to deduct the part of a casualty or theft loss for which you are reimbursed.

If you expect to be reimbursed, but have not yet received payment, you must still subtract the expected reimbursement from the loss. See *When to Deduct a Loss,* later.

If you receive reimbursement that is more than your basis in the property, you have a gain. You have a gain only if the reimbursement is more than your basis; it makes no difference if the reimbursement is more than the decrease in fair market value. If you have a gain, you may have to pay tax on it, or you may be able to postpone reporting the gain.

See Publication 547 for more information on how to treat a gain from the reimbursement for a casualty or theft.

Reimbursement. Insurance is the most common way to be reimbursed for a casualty or theft loss. But you might also be reimbursed in some other way:

- If part of a federal disaster loan under the Disaster Relief Act of 1970 is forgiven, the part you do not have to pay back is considered a reimbursement.
- If the person who leases your property must make repairs or must repay you for any part of a loss, the repayment and the cost of the repairs are considered reimbursements.
- If a court awards you damages for a casualty or theft loss, the amount you are able to collect, minus lawyers' fees and other necessary expenses, is a reimbursement.
- If you accept repairs, restoration, or cleanup provided by relief agencies, it is considered a reimbursement.
- If a bonding company pays you for a theft loss, the payment is also a reimbursement.

Grants, gifts, and other payments you receive to help you after a casualty are considered reimbursement ***only*** if they are specifically designated to repair or replace your property. If there are no conditions on how you have to use the money you receive, it is not a reimbursement even if you use it to restore your property.

Living costs. If an insurance company pays you for any of your living expenses after you lose the use of your home because of a casualty, the insurance payments are not considered a reimbursement for your casualty loss. They do not reduce your casualty loss.

The part of insurance payments that represents a temporary increase in the living expenses you and your family have during this period does not have to be reported as income. The increase in your living expenses is the excess of your actual living expenses over your normal living expenses.

Do not include in income the payment you received for your extra expenses for renting suitable housing and for transportation, food, utilities, and miscellaneous services during the period you are unable to use your home because of the casualty. However, you must report as income the part of the insurance payments that cover your normal living expenses.

Example. As a result of a fire, you vacated your apartment for a month and moved to a motel. You normally pay $525 a month rent. None was charged for the month the apartment was vacated. Your motel rent for this month was $1,200. You received $1,100 reimbursement from your insurance company for rental expenses.

The part of the insurance payment that reimburses you for the increase of your actual rent over your normal rent is $675 ($1,200 − $525). You do not include this amount in income. But you must include in income the rest of the insurance received, $425 ($1,100 − $675).

If you are denied access to your home by government authorities due to a casualty or the threat of a casualty, the same rule applies.

Disaster relief. Food, medical supplies, and other forms of assistance that you receive do not reduce the amount of your casualty loss unless they are replacements for lost or destroyed property. These items are also not taxable income to you.

$100 Rule

The first $100 of a casualty or theft loss on nonbusiness property is not deductible. This rule applies after all reimbursements have been taken into account.

Single event. A single $100 reduction applies to each individual casualty or theft, no matter how many pieces of property are involved.

Generally, events closely related in origin are considered a single casualty or theft. It is a single casualty when the damage is from two or more closely related causes, such as wind and flood damage caused by the same storm. A single casualty may also damage two or more widely separated pieces of property, such as a hail storm that damages both your home and your car parked downtown.

More than one loss. If you have more than one casualty or theft during your tax year, you must reduce ***each*** loss by $100.

Example. Your family car was damaged in an accident in January. Your loss, after the insurance reimbursement, was $75. In February your car was damaged in another accident and this time your loss after the insurance reimbursement was $90. The $100 rule must be applied to each separate casualty loss. Since neither accident resulted in a loss of over $100, you are not entitled to any deduction for these accidents.

More than one person. If two or more individuals (other than a husband and wife) have losses from the same casualty or theft, the $100 rule applies separately to each.

Example. Your house is damaged by a fire that also damages the personal property of your house guest. You must reduce your loss by $100 and your guest must reduce his or her loss by $100.

Married taxpayers. If you and your spouse have a casualty or theft loss and you file a joint return, you are treated as one individual in applying the $100 rule. It does not matter whether you own the property jointly or separately.

However, if you file separate returns, each of you must reduce your loss by $100, even if the property is owned jointly. If the property is owned separately by a spouse, only that spouse can figure a loss deduction on a separate return.

If you and your spouse file separate returns and have a casualty loss on property you own together, each of you may figure your deduction on only one-half of the loss on your separate return. Neither of you may figure your deduction on the entire loss on a separate return. Each of you must reduce the loss by $100.

More than one owner. If two or more individuals (other than husband and wife) have a loss on property that is jointly owned, the $100 rule applies separately to each. For example, if two sisters live together in a home they own jointly and they have a loss on the home because of a casualty, the $100 rule applies separately to each.

10% Rule

You may deduct a casualty or theft loss to nonbusiness property only if your loss is more than 10% of your adjusted gross income (line 32 of Form 1040). This rule applies ***after*** you have first reduced the loss by any reimbursements and by $100. However, if you also have casualty or theft gains, see *Gains and losses*, later in this discussion.

Example. In June you discovered that your house had been robbed. Your loss after insurance reimbursement was $2,000. Your adjusted gross income is $29,500. To figure your deduction, you first apply the $100 rule and then the 10% rule. Your loss after applying the $100 rule is $1,900 ($2,000 − $100). When you apply the 10% rule, you find you do not have a casualty or theft loss deduction because your loss ($1,900) is less than 10% of your adjusted gross income ($2,950).

More than one loss. If you have more than one casualty or theft loss during your tax year, you must reduce the ***total*** of all your losses (after you have reduced ***each*** loss by $100) by 10% of your adjusted gross income.

Example. In March you had a car accident that totally destroyed your car. You did not have collision insurance on your car, so you did not receive any insurance reimbursement. Your loss on the car was $1,200. In November, you had a fire that damaged your basement and totally destroyed the furniture, washer, dryer, and other items you had stored there. Your loss after reimbursement was $1,700. Your adjusted gross income is $25,000. You figure your casualty loss deduction as follows:

Loss on car	$1,200	
Minus: $100	100	$1,100
Loss to basement, etc.	$1,700	
Minus: $100	100	1,600
Total losses		$2,700
Minus: 10% of $25,000		2,500
Casualty loss deduction		$ 200

Married taxpayers. If you and your spouse have a loss from the same casualty or theft, and you file a joint return, you are treated as one individual in applying the 10% rule. It does not matter if you own the property jointly or separately.

More than one owner. If two or more individuals (other than husband and wife) have a loss on property that is owned jointly, the 10% rule applies separately to each.

Gains and losses. If you had both gains and losses from casualties or thefts to nonbusiness property, special rules apply. If your total losses are more than your total gains, only the excess losses are subject to the 10% rule. However, if your total gains are more than your total losses, the gains and losses will be treated as capital gains and losses and none of the losses will be subject to the 10% rule.

For more information, see Publication 547.

Figuring the Deduction

Generally, you must figure your loss separately for each individual item that is stolen, damaged, or destroyed. However, for nonbusiness real property, an entire piece of real estate is considered one item.

Real property. Real property is land, the plants and trees that grow on land, and the buildings and other structures that are placed on land. In figuring a loss to real property that you own for personal use, all improvements, such as buildings and ornamental trees, are considered together. The amount of the loss is either the decrease in the fair market value of the entire property or its adjusted basis, whichever is less. From this amount you must subtract any insurance or other reimbursement you receive or expect to receive. Then you must subtract $100. If this was your only casualty or theft loss, you would then subtract 10% of your adjusted gross income (AGI). (However, if you have other casualty or theft losses, then you would subtract 10% of your AGI from the total of all your losses.) Any amount remaining is your personal casualty loss deduction.

Example. A few years ago you bought a house, which you then lived in as your home. You paid $10,000 for the land and $40,000 for the house. You also spent $2,000 for landscaping. This year your home was totally destroyed by fire. The fire also damaged the shrubbery and trees in your yard. The fire was your only casualty or theft loss this year. Competent appraisers valued the property as a whole at $75,000 before the fire, but at only $15,000 after the fire. (The loss to your household furnishings is not shown in this example but would be figured separately, as explained later.) Shortly after the fire, the insurance company paid you $45,000 for the loss. Your adjusted gross income is $48,000. You figure your casualty loss deduction as follows:

1) Adjusted basis of the entire property (cost of land, building, and landscaping)	$52,000
2) Value of entire property before fire	$75,000
3) Value of entire property after fire	15,000
4) Decrease in fair market value of entire property	$60,000
5) Amount of loss (lesser of 1 or 4)	$52,000
6) Minus: Insurance	45,000
7) Loss after reimbursement	$ 7,000
8) Minus: $100	100
9) Loss after $100 rule	$ 6,900
10) Minus: 10% of $48,000	4,800
11) **Casualty loss deduction**	$ 2,100

Personal property. Personal property is generally any property that is not real property. If your personal property is stolen or is damaged or destroyed by a casualty, you must figure your loss separately for each item of property.

The amount of the loss is either the decrease in the fair market value of the property or its adjusted basis, whichever is less. From this amount you must subtract the insurance and other reimbursement you receive or expect to receive. Then you must subtract $100. If this was your only casualty or theft loss, you would then subtract 10% of your adjusted gross income (AGI). (However, if you have other casualty or theft losses, then you would subtract 10% of your AGI from the total of all your losses.)

Example. A fire in your home completely destroyed an upholstered chair, an oriental rug, and an antique table. You did not have fire insurance to cover your loss. (This was the only casualty or theft you had during the year.) The chair cost you $750, and you established that it had a fair market value of $500 just before the fire. The rug cost you $3,000 and had a value of $2,500 just before the fire. You bought the table at an auction for $100, before discovering it was an antique. It had been appraised at $900 before the fire. Your adjusted gross income is $27,000. You figure your loss on each of these items as follows:

	Chair	Rug	Table
1) Basis (cost)	$ 750	$3,000	$ 100
2) Value before fire	$ 500	$2,500	$ 900
3) Value after fire	-0-	-0-	-0-
4) Decrease in value	$ 500	$2,500	$ 900
5) Loss (lesser of 1 or 4)	$ 500	$2,500	$ 100
6) Total loss			$3,100
7) Minus: $100			100
8) Loss after $100 rule			$3,000
9) Minus: 10% of $27,000			2,700
10) Casualty loss deduction			$ 300

Both real and personal property. When a casualty involves both real and personal property, you must figure the amount of the loss separately for each type of property, as discussed above. However, you apply a single $100 reduction to the total loss. Then you apply the 10% rule.

Property used partly for business and partly for personal purposes. When property is owned partly for personal use and partly for business or income-producing purposes, the casualty or theft loss deduction must be figured separately for the non-business portion and for the business portion. You must figure the loss separately because the portion of the loss attributed to these two categories is figured in two different ways. The $100 rule and the 10% rule apply only to the casualty or theft of the nonbusiness property.

When to Deduct a Loss

A casualty usually is apparent when it happens; a theft may not be discovered until a later time. This affects the year in which you may deduct a casualty or a theft loss.

Casualty losses. Generally, you may deduct casualty losses only in the tax year in which the casualty occurred. (However, if your casualty loss is due to a loss on deposits at an insolvent or bankrupt institution, see *Loss on deposits*, later.) This is true even if the damaged property is not repaired or replaced until the next year.

Disaster area losses. If you have a loss in a federally declared disaster area, you may choose to deduct the loss on your tax return for the year immediately preceding the year in which the disaster occurred. This may enable you to get an immediate refund of taxes you already paid. For more information, see Publication 547.

Leased property. If you are liable for casualty damage on property you lease from someone else, you must deduct your loss in the year you pay off your liability.

Theft losses. You may generally deduct a theft loss only in the year you discover that your property is missing. You must be able to show that there was a theft, but you do not have to know when the theft took place.

Loss on deposits. You may choose to deduct a loss on deposits with an insolvent or bankrupt financial institution as a casualty loss. You can make this choice when you can reasonably estimate how much you have lost. Generally, if you recover an amount that you claimed as a casualty loss, you must include the amount recovered in income. If you decide not to deduct the loss as a casualty loss, you may deduct it as a nonbusiness bad debt. To deduct the loss as a nonbusiness bad debt, you must wait until the actual amount of the loss is determined. For more information on bad debts, see Chapter 16.

Reimbursement. If there is a reasonable prospect that you will be reimbursed for part or all of your loss, you must subtract the expected reimbursement to figure your loss. You must reduce your loss even if you do not receive payment until a later tax year. You are believed to have a reasonable prospect of being reimbursed if you have filed suit for damages.

If you later receive less reimbursement than you expected, you include that difference as a loss with your other losses (if any) on your return for the year in which you find that you can reasonably expect no more reimbursement.

Example. Your personal car had a fair market value of $2,000 when it was destroyed in a collision with another car in 1987. The accident was due to the negligence of the other driver. At the end of the year there was a reasonable prospect that you would be fully reimbursed by the owner of the other car. Therefore, you do not have a deductible loss in 1987.

In January 1988 the court awards you a judgment of $2,000, but in July it becomes apparent that you will be unable to collect any amount from the other driver. Since this is your only casualty or theft loss, you may claim a loss in 1988 of the amount that is more than $100 and 10% of your 1988 adjusted gross income.

If you later receive more reimbursement than you expected, you may have to report the difference as income. That is, if you take a deduction for a casualty or theft loss in one year, and then in a later year you receive a reimbursement that covers any part of the deduction, that part of the reimbursement may be considered income.

However, if any part of your deduction for the loss did not actually lower the amount of your tax, you do not include that part of the reimbursement in your income.

For more information, see *Recoveries* in Chapter 13.

Note: If the total of all the reimbursements you receive is ***more than your adjusted basis*** in the destroyed or stolen property, you will have a gain on the casualty or theft rather than a loss. If you have already taken a deduction for a loss, you must report the amount of your deduction as income, if it lowered the amount of your tax, and report your gain. See Publication 547 for more information on how to treat a gain from the reimbursement of a casualty or theft.

Worksheet. Publication 525, *Taxable and Nontaxable Income*, has a worksheet for you to use when only part of your original deduction reduced the amount of your tax in the earlier year.

If you receive exactly the amount of reimbursement you expected to receive, you will have no amount to include in your income and no amount to deduct.

Example. In December 1987 you had a collision while driving your personal car. Repairs to the car cost $950. You had $100 deductible collision insurance, and your insurance company agreed to reimburse you for the rest of the damage. As a result of your expected reimbursement from the insurance company, you do not have a casualty loss deduction in 1987.

Due to the $100 rule, you may not deduct the $100 the insurance company did not reimburse you. When you receive the $850 from the insurance company in 1988, you do not have to report it as income.

Recovered property is your property that was stolen and later returned to you. If you recovered property after you have already taken a theft loss deduction, you must refigure the amount of your loss.

Refigure your loss by:

1) Comparing the property's cost (plus or minus certain adjustments) to its decrease in value from the time it was stolen until the time it was recovered,
2) Taking the lower of these amounts, subtracting any reimbursements (such as insurance) you received, and
3) Subtracting $100 and 10% of your AGI of the loss year.

This is your refigured loss. Generally, if this amount is less than the amount you deducted for the loss, you have to report the difference as income. However, you only have to report as income the amount of the theft loss deduction that reduced your tax.

How to Report a Loss

If you have a deductible casualty or theft loss from nonbusiness property, you may claim this loss only on Schedule A (Form 1040).

If by the end of 1988 you can make a reasonable estimate of a loss on deposits in an insolvent or bankrupt financial institution, you may choose to deduct it as a casualty loss. This loss is entered on Form 4684. You have to make the choice on the return for the year in which you can reasonably estimate that the loss occurred. You cannot make the choice later on an amended return.

However, if you make a reasonable estimate that the loss occurred in 1985, you may choose to claim a casualty loss on an amended return, Form 1040X. The amended return must normally be filed within 3 years from the date you filed your original return, or 2 years from the date you paid the tax for that year, whichever date is later. Once you have treated the loss as a casualty loss, you cannot treat it as a nonbusiness bad debt when it actually becomes worthless.

Form 4684. If you have a casualty or theft on nonbusiness property, you must use Section A of Form 4684, *Casualties and Thefts*, to figure and report your gain or loss. Be sure to attach Form 4684 to your return.

You must list each item or article for which you are reporting a casualty or theft on Form 4684. If more than four items of property were stolen or damaged in a single casualty or theft, attach additional sheets following the format of lines 1 through 9 of Form 4684. If you have to figure your loss on many different personal and household items, you may want to use the worksheets in Publication 584. Copies of these worksheets can be used in place of the additional Forms 4684.

If you had more than one casualty or theft during the year, you must complete lines 1 through 12 on separate Forms 4684 for each casualty or theft. Use only one Form 4684 for lines 13 through 18.

Loss. If you have a deductible loss from nonbusiness property, transfer the amount from line 18 of Section A, Form 4684, to line 18 of Schedule A (Form 1040). Schedule A is used to itemize deductions. If you do not itemize deductions, you cannot deduct your casualty or theft loss.

Gain. If you have a gain from nonbusiness property, this amount will be shown on line 15 of Section A, Form 4684. You may also have to complete Schedule D (Form 1040). For more information, see Publication 547.

Business property. If you have a casualty or theft on business property, on property that earns you rent or royalty income, or on other income-producing property, you must use Section B of Form 4684 to figure and report your gain or loss. For more information, see Publication 549.

Adjustments to basis. After you take a casualty or theft loss deduction, you must subtract the amount of your deduction plus any reimbursement from your basis in the damaged, destroyed, or stolen property. The result is a new, lower total for your basis in the property. In some cases, this lower basis will carry over to any property you get to replace the property that was stolen or destroyed.

See Chapter 15 for more information on basis.

Net operating loss. If your casualty or theft losses are more than your income, you may have a net operating loss. A net operating loss can be used to lower your taxes in an earlier year, allowing you to get a refund for taxes that you have already paid. Or it can be used to lower your taxes in a later year. You do not have to be in business to have a net operating loss from a casualty or theft.

For more information on net operating losses, see Publication 536, *Net Operating Losses.*

28. Moving Expenses

If you changed job locations or started a new job, you may be able to deduct some of your moving expenses. You may qualify for a deduction whether you are self-employed or an employee. However, you must meet the *Requirements*, explained later.

If you retire while living and working overseas, or if you are the survivor (spouse or dependent) of a person whose main job location at the time of death was outside the United States, you may be able to deduct your expenses of moving back to the United States. See *Retirees or Survivors* under *Requirements*, later.

Moves outside the United States. If you are a U.S. citizen or resident alien who moved outside the United States or its possessions because of your job or business, see Publication 521, *Moving Expenses*, for special rules that apply to your move.

Requirements

You may deduct a limited amount of your moving expenses if you meet the distance test and the time test, discussed later. Your move must also be closely related, both in time and place, to the start of work at your new job location.

Closely related to the start of work. In general, moving expenses incurred within one year from the date you first reported to work are considered closely related in time to the start of work at the new location. It is not necessary that you make arrangements to work before moving to a new location, as long as you actually do go to work. If you do not move within one year, you ordinarily may not deduct the expenses unless you can show that circumstances existed that prevented the move within that time. For example, if to allow your child to complete high school in the same school, your family moved more than a year after you started work at the new location, you may deduct your otherwise allowable moving expenses.

A move is generally not closely related in place to the start of work if the distance from your new home to the new job location is greater than the distance from your former home to the new job location. However, a move may be considered closely related in place to the start of work if you can show that:

1) You are required to live at your new home as a condition of employment, or
2) You will spend less time or money commuting from your new home to your new job.

Although a move may be considered to be closely related to the start of work, both in time and place, you are still required to meet the distance and time tests in order to be eligible for the moving expense deduction.

Home. Your home means your main home (residence). It may be a house, apartment, or condominium. It also may be a houseboat, housetrailer, or similar dwelling. Your ***former home*** means your home before you left for your new job location. Your ***new home*** means your home within the area of your new job location. Your home does not include other homes owned or kept up by you or members of your family. It also does not include a seasonal home, such as a summer beach cottage.

Distance Test

Your move will meet the distance test if your new main job location is at least 35 miles farther from your former home than your old main job location was. For example, if your old job was 3 miles from your former home, your new job must be at least 38 miles from that former home.

The distance between two points is the shortest of the more commonly traveled routes between those points. The distance test does not apply to the location of your new home.

Example. You moved to a new home less than 35 miles from your former home because you changed job locations. Your old job was 3 miles from your former home. Your new job is 40 miles from that home. Because your new job is 37 miles farther from your former home than the distance from your former home to your old job, you meet the 35–mile distance test.

First job or return to full-time work. If you go to work full time for the first time, or go back to full-time work after a substantial period of part-time work or of unemployment, your place of work must be at least 35 miles from your former home to meet the distance test.

Exception. If you are in the armed forces and you moved because of a permanent change of station, you do not have to meet the distance test. See *Members of the Armed Forces*, later.

Main job location. Your main job location is usually the place where you spend most of your working time. A new job location is a new place where you will work permanently or indefinitely rather than temporarily. If there is no one place where you spend most of your working time, your main job location is the place where your work is centered—for example, where you report for work or are otherwise required to "base" your work.

If you work for a number of employers on a short-term basis and you get work under a union hall system, such as a construction or building trades worker, your main job location is the union hall.

More than one employer. If you have more than one employer at any time, your main job location depends on the facts in each case. The more important factors to be considered are the total time you spent at each place, the amount of work you did at each place, and the money you earned at each place.

Time Test

To deduct your moving expenses, you also must meet one of the following time tests.

Time test for employees. If you are an employee, you must work full time for at least 39 weeks during the first 12 months after you arrive in the general area of your new job location. You do not have to work for one employer for the 39 weeks. However, you must work full time within the same general commuting area. You do not have to work 39 weeks in a row. Whether you are employed full time depends on the custom for your type of work.

Seasonal work. If your work is seasonal, you are considered to be working full time during the off-season only if your work contract or agreement covers an off-season period and that period is less than 6 months. For example, a school teacher on a 12–month contract who teaches on a full-time basis for more than 6 months is considered a full-time employee for 12 months.

Temporary absence from work. You are considered to be working full time during any week you are temporarily absent from work because of illness, strikes, shutouts, layoffs, natural disasters, or similar causes. You are also considered to be a full-time employee during any week you are absent from work for leave or vacation that is provided for in your work contract or agreement.

Time test for self-employed persons. If you are self-employed, you must work full time for at least 39 weeks during the first 12 months and for a total of at least 78 weeks during the first 24 months after you arrive in the area of your new job location.

Whether you perform services full time during any week depends on the custom for your type of work in your area.

You are self-employed if you work as the sole owner of an unincorporated business or as a partner in a partnership carrying on a business.

If you are an employee and become self-employed before satisfying the 39-week test for employees, you meet the time test if you satisfy the 78-week test for self-employed persons.

If you are self-employed and become an employee before satisfying the 78-week test, you may use the time spent as a full-time employee to satisfy the 78-week test if you cannot satisfy the 39-week test for employees.

For more information, see *Time test for self-employed persons* in Publication 521.

Joint return. If you are married and file a joint return and both you and your spouse work full time, either of you may satisfy the full-time work test. However, you may not add the weeks your spouse worked to those you worked to satisfy that test.

Time test not met. You may deduct your moving expenses even if you have not met the time test by the date your 1988 return is due. You may do this if you expect to meet the 39-week test in 1989 or the 78-week test in 1990. If you do not meet the time test by then, you either must amend your 1988 return or report your moving expense deduction as other income on your Form 1040 for the year you cannot meet the test. Use Form 1040X, *Amended U.S. Individual Income Tax Return,* to amend your return.

If you do not deduct your moving expenses on your 1988 return, and you later meet the time test, you may file an amended return for 1988, taking the deduction.

Note. If your moving expenses become nondeductible because you did not meet the time test, you may use the part of these expenses that is for the sale or exchange of your former home to lower the gain on the sale of your former home. The part of these expenses that is for the purchase of your new home may be added to the basis of your new home. For more information, see Chapter 17.

Exceptions to the Time Test

You do not have to meet the time test if one of the following applies:

1) You are in the armed forces and you moved because of a permanent change of station—see *Members of the Armed Forces,* later,
2) You moved to the United States because you retired—see *Retirees or Survivors,* later,
3) You are the survivor of a person whose main job location at the time of death was outside the United States—see *Retirees or Survivors,* later,
4) Your job at the new location ends because of disability, or
5) You are transferred for your employer's benefit or laid off other than for willful misconduct. If you are transferred from your new job location or laid off other than for willful misconduct, you must have expected to meet the test at the time you started the job.

The time test also does not have to be met in case of death.

Members of the Armed Forces

If you are a member of the armed forces on active duty and you move because of a permanent change of station, you may deduct a limited amount of your unreimbursed moving expenses. The limits are discussed later. You do not have to meet the ***distance and time tests,*** discussed earlier.

A permanent change of station includes:

1) A move from your home to the area of your first post of duty when you begin active duty,
2) A move from your last post of duty to your home or a nearer point in the United States, if you move within one year of ending your active duty or within the period allowed under the Joint Travel Regulations, or
3) A move from one permanent post of duty to another.

If a member of the armed forces deserts, is imprisoned, or dies, a permanent change of station for the spouse or dependent includes a move to the place of enlistment, or to the member's, spouse's, or dependent's home of record, or nearer point in the United States.

If the military moves you and your spouse and dependents to or from separate locations, the moves are treated as a single move to your new main job location.

Services or reimbursements provided by government. Do not include in income the value of moving and storage services provided by the government in connection with a permanent change of station. However, if you receive reimbursements or allowances from the government for moving and storage expenses in connection with a permanent change of station, and the reimbursements or allowances are more than your actual moving expenses, include the excess in income. If your reimbursements or allowances are less than your actual moving expenses, do not include the reimbursements or allowances in income.

If you are required to relocate, and your spouse and dependents move to or from a different location, do not include in income reimbursements, allowances, or the value of moving and storage services provided by the government to move you and your spouse and dependents to and from the separate locations.

Do not deduct any expenses for moving services that were provided by the government or that were reimbursed to you and that you did not include in income.

Retirees or Survivors

If you meet the following requirements, you may be able to deduct a limited amount of your expenses to move to the United States. For this purpose, the term "United States" includes the possessions of the United States. You do not have to meet the ***time test,*** discussed earlier.

Retirees. You may deduct moving expenses for a move to a new home in the United States when you permanently retire, if both your former main job location and your former home were outside the United States.

You are considered permanently retired when you cease gainful full-time employment or self-employment. If at the time you retire you intend your retirement to be permanent, you will be considered retired even though you later return to work. Your intention to retire permanently will be determined by your age and health, the customary retirement age for people who do similar work, whether you are receiving retirement payments from a pension or retirement fund, and the length of time before your return to full-time work.

Survivors. You may deduct moving expenses for a move to a home in the United States if you are the spouse or the dependent of a person whose main job location at the time of death was outside the United States. The move must begin within 6 months after the decedent's death and must be from a former home outside the United States that you lived in with the decedent at the time of death.

A move begins when:

1) You contract for your household goods and personal effects to be moved to your home in the United States. The move must be completed within a reasonable time,
2) Your household goods and personal effects are packed and on the way to your home in the United States, or
3) You leave your former home to travel to your new home in the United States.

Deductible Moving Expenses

If you meet the *Requirements* discussed earlier, you may deduct the reasonable expenses of:

1) Moving your household goods and personal effects (including certain storage expenses),
2) Traveling to your new home,
3) Househunting trips before you move,
4) Living temporarily in the new area, and
5) Disposing of your former home and getting a new one.

Note. The expenses listed in items (3), (4) and (5) above are subject to the *Dollar limits,* explained later.

Reasonable expenses. You may deduct only those expenses that are reasonable for the circumstances of your move. For example, the cost of traveling from your former home to your new one should be by the shortest, most direct route available by conventional transportation. If, during your trip to your new home, you make side trips for sightseeing, the additional expenses for your side trips are not deductible as moving expenses.

Travel by car. If you use your car for househunting or to take yourself, members of your household, or your things to your new home, you may figure your expenses by either deducting:

1) Your actual expenses, such as gas and oil for your car, if you keep an accurate record of each expense, or
2) 9 cents a mile if you can prove the mileage traveled. You also may deduct parking fees and tolls you paid in moving. You may not deduct any part of general repairs, general maintenance, insurance, or depreciation.

Member of household. You may deduct moving expenses you pay for yourself and members of your household. A member of your household is anyone who has both your former and new home as his or her home. It does not include a tenant or employee, unless you may claim that person as a dependent.

Household Goods and Personal Effects

You may deduct the cost of packing, crating, and transporting your household goods and personal effects and those of the members of your household (defined earlier) from your former home to your new one. If you use your own car to move your things, see *Travel by car,* earlier. You may also include the cost of storing and insuring household goods and personal effects within any consecutive 30-day period after the day your things are moved from your former home and before they are delivered to your new one.

You may deduct any costs of connecting or disconnecting utilities required because of the moving of household goods, appliances or personal effects.

You may deduct the cost of shipping your car and household pets to your new home.

You may deduct the cost of moving household goods and personal effects from a place other than your former home only up to the amount it would have cost to move them from your former home.

You may not deduct the cost of moving furniture you buy on the way to your new home.

Travel Expenses

You may deduct the cost of transportation, meals, and lodging for yourself and members of your household (defined earlier) while traveling from your former home to your new home. However, the cost of your meals may be limited to 80%. See *80% Limit on Meals,* discussed later. This includes expenses for the day you arrive. You may also include any meal and lodging expenses you had in the area of your former home within one day after you could not live in your former home because your furniture had been moved. You may deduct expenses for only one trip to your new home for yourself and members of your household. However, all of you do not have to travel together. If you use your own car, see *Travel by car,* earlier.

80% Limit on Meals

You may be able to deduct only 80% of the cost of meals (food and beverages) you incur during your househunting trip, while traveling to your new residence, and while staying in temporary quarters. This limit applies before all other moving expense limits.

You will not be subject to the 80% limit if you receive payments for these expenses from your employer and your employer does not treat the expense as compensation paid to you.

Caution: As this publication was being prepared for print, Congress was considering legislation that would limit your deduction for meal expenses, that are deductible as moving expenses, to 80%, even if your employer paid or reimbursed you for them. Your employer would not be subject to the 80% limit.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Allocation of meals reimbursement. If you receive a partial reimbursement for moving expenses from your employer, you must allocate the reimbursement for meals among the cost of your meals for your move from your old residence to your new residence, the cost of your meals during your househunting trip, and the cost of your meals while in temporary quarters, if your employer does not do so. This allocation is in addition to any allocation you must make among other moving expenses.

If you are self-employed, you are subject to the 80% limit on meals.

Lavish or extravagant meals. The cost of meals you and your family incur during your move may not be lavish or extravagant under the circumstances.

Pre-Move Househunting Expenses

Househunting expenses include the cost of transportation, meals (discussed earlier), and lodging for yourself and members of your household (defined earlier) while traveling to and from the area of your new job and while you are there. You may deduct these expenses only if you begin your trip after you get a job in the new area, and you go primarily to look for a new place to live. Your househunting does not have to be successful to qualify for this deduction. You and members of your household may travel separately. There is no limit to the number of trips you or members of your household may take. However, see *Dollar Limits,* later. If you use your own car, see *Travel by car,* earlier.

If you are ***self-employed,*** see *Self-employed,* under *Temporary Living Expenses,* following.

Temporary Living Expenses

Temporary living expenses include only the costs of meals (discussed earlier) and lodging while occupying temporary quarters in the area of your new job. You may deduct these costs, subject to the *Dollar Limits,* discussed later, for any 30 days in a row after you get the job, but before you move into permanent quarters.

Self-employed. If you are self-employed, do not deduct your expenses for pre-move househunting trips or temporary living expenses unless you have made substantial arrangements to begin work at the new location. See Publication 521 for more information.

Home-Related Expenses

You may deduct the reasonable expenses of disposing of your former home and getting a new one.

Home sale or exchange expenses. When you sell or exchange your former home, you may deduct as moving expenses real estate commissions, attorney's fees, title fees, escrow fees, points or loan placement charges you are required to pay, state transfer taxes, and similar expenses connected with the sale or exchange.

You may ***not*** deduct as a moving expense the cost of physical improvements intended to improve the condition or appearance of your former home.

Home purchase expenses. When you buy your new home, you may deduct attorney's fees, escrow fees, appraisal fees, title fees, points or loan placement charges that do not represent payment or prepayment of interest, and similar expenses connected with the purchase.

No double benefit. The expenses of selling or exchanging your former home that you include as part of your moving expense deduction may not be used to reduce the amount realized on the sale of your former home. The expenses of buying your new home that are included in your moving expense deduction may not be added to the basis of your new home. See Chapter 17 for information on selling and buying your home.

Unexpired lease expenses. When you end an unexpired lease on your former home, you may deduct payments to the lessor for releasing you from the lease, attorney's fees, real estate commissions, and expenses such as the difference between the rent you pay and the rent you receive from an assignee or sublessee.

Expenses of leasing a new home. When you lease a new home, you may deduct attorney's fees and commissions. These expenses may be for leasing, subleasing, or taking an assignment of a lease. You may ***not*** deduct payments or prepayments of rent. See *Security deposit,* later.

Dollar Limits

The expenses of moving household goods and traveling to your new home are not limited to any amount. However, the combined total of all your other moving expenses may not be more than $3,000. Of the $3,000 limit, no more than $1,500 may be deducted for househunting trip expenses and temporary living expenses combined. Exceptions are explained later under *Married persons filing separate returns* and *Married persons filing a joint return.*

Homeowners. If you are a homeowner, you should claim pre-move househunting expenses and temporary living expenses, up to $1,500, before you claim the expenses of selling and buying your home. However, within the dollar limits, you may choose to deduct any combination of these expenses. Any expenses for selling your home that you may not deduct because of the $3,000 limit should be used to reduce the gain on the sale of your former home. Use any expenses for buying your home that you may not deduct because of the limit to increase the basis of your new home.

Married persons filing separate returns. If both of you began work at new job locations and lived together, the dollar limit is $1,500 for each of you for househunting trips, temporary living expenses, and expenses of selling and buying a home.

No more than $750 for each of you may be deducted for househunting and temporary living expenses.

If only one of you began work at a new job location, the limit for that person is $3,000 for househunting trips, temporary living expenses, and expenses of selling and buying a home. No more than $1,500 may be deducted for househunting and temporary living expenses.

If both of you began work at new job locations, but you have not shared the same new home by the end of the tax year or made plans to do so, the limit for each of you is $3,000 for househunting trips, temporary living expenses, and expenses of selling and buying a home. No more than $1,500 for each of you may be deducted for househunting and temporary living expenses.

Example. Tim and Mary Brown are married, but separated. Tim moved from New York to Michigan. His moving expenses were $3,600 for househunting trips, temporary living expenses, and selling his home. Mary moved from New York to Washington, DC. Her moving expenses were $3,200 for househunting trips, temporary living expenses, and selling her home. Neither had more than $1,500 in expenses for househunting trips and temporary living expenses. Each may claim $3,000 on a separate return.

Married persons filing a joint return. If both of you began work at new job locations, but at the end of the tax year have not shared the same new home or made plans to do so, the limit is $6,000 for househunting trips, temporary living expenses, and expenses of selling and buying a home. No more than $3,000 may be deducted for househunting and temporary living expenses. However, of the $6,000 and $3,000 limits, each of you is limited to $3,000 for househunting trips, temporary living expenses, and expenses of selling and buying a home, and to $1,500 for househunting and temporary living expenses.

If you shared the same new home, the limit for both of you together is $3,000 for househunting trips, temporary living expenses, and expenses of selling and buying a home. Of the $3,000 limit, no more than $1,500 may be deducted for househunting and temporary living expenses.

Nondeductible Expenses

You may not deduct the following as moving expenses:

- Home improvements to help sell your home
- Loss on the sale of your home
- Mortgage penalties
- Losses from disposing of memberships in clubs
- Any part of the purchase price of your new home
- Real estate taxes
- Car tags
- Driver's license
- Refitting carpets and draperies
- Storage charges except those incurred in-transit and foreign moves

Security deposit. Do not deduct a security deposit you paid when you signed a new lease. Do not deduct a security deposit that you gave up because the vacated space needed cleaning or redecorating when you ended the lease. However, you may deduct a security deposit that you gave up if you broke the lease as a result of the move.

Temporary employment. You may not take a moving expense deduction and a business expense deduction for the same expenses. You must determine if your expenses are deductible as moving expenses or as business expenses. For example, expenses you have for travel, meals, and lodging while temporarily working at a place away from your regular place of work are deductible as business expenses if you are considered away from home on business. Your work is considered temporary if its end can be foreseen within a reasonably short time, usually less than one year, and your main job location or post of duty does not change. See *Temporary assignment or job* in Chapter 19 for information on deducting your expenses.

How to Report

The following discussions explain how to report your moving expenses and any reimbursements or allowances you received for your move.

Form 3903. Use Form 3903, *Moving Expenses*, to report your moving expenses if your move was within or to the United States or its possessions. A filled-in Form 3903 is shown in Chapter 38.

Where to deduct. In order to claim the moving expense deduction, you must itemize your deductions on Schedule A (Form 1040). The amount of moving expenses you may deduct is shown on line 23, Form 3903. Enter this amount on line 19, Schedule A (Form 1040).

Reimbursements. You must include all reimbursements of, or payments for, moving expenses in gross income for the year you receive them. If your employer paid for any part of your move, you must report that amount as income on line 7, Form 1040. Your employer must include the amount in Box 10, *Wages, tips, other compensation*, on your Form W-2, *Wage and Tax Statement*. A separate Form W-2 may be provided.

Allowance in kind. You must also include in your income the value of moving services provided by your employer to you or members of your family. You include this amount in income in the year you receive the services. If your employer paid someone to provide the services, you must include the amount paid in your income in the year your employer made the payment. Your employer must also include any allowance in kind in the total income on your Form W-2.

Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970. Do not include in income any moving expense payments you received under the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970. These payments are made to persons displaced from their homes, businesses, or farms by federal projects.

Tax withholding. Your employer is not required to withhold income tax or social security tax on allowances or reimbursements for moving expenses if your employer reasonably believes that you will be able to deduct the expenses. This means that at the time your employer pays you the reimbursement or allowance, your employer reasonably believes that you will meet the distance and time tests, and that your expenses will be deductible.

For more information on tax withholding, see Publication 521.

Caution: As this publication was being prepared for print, Congress was considering legislation that would for employment tax purposes exclude your meal reimbursements from your wages if at the time you were paid, it was reasonable to believe that a corresponding moving deduction would be allowable as determined without regard to the 80% limit.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

For information on taking additional withholding allowances for your moving expenses, see Chapter 5.

Form 4782. Your employer must give you an itemized list of payments, reimbursements, or allowances paid to you as moving expenses. Form 4782, *Employee Moving Expense Information*, may be used for this purpose. See Publication 521 for a filled-in Form 4782.

When to deduct. Deduct your moving expenses in the year you had them or paid them. If you use the cash method of accounting, which is used by most individuals who are not self-employed, you may choose to deduct moving expenses in the year you are reimbursed by your employer if:

1) You paid the expenses in a year before the year of reimbursement, or
2) You paid the expenses in the year immediately after the year of reimbursement but by the due date, including extensions, for filing your return for the reimbursement year.

You may choose to deduct moving expenses in the year that you received reimbursement by taking the deduction on your return, or amended return, for that year.

The following examples explain these rules:

Example 1. In December 1987, your employer transferred you to another city, where you still work. You are single and were not reimbursed for your moving expenses. In 1987 you paid for a househunting trip, travel to the new city, temporary living expenses, and moving your furniture. You deducted these expenses in 1987. In 1988 you paid additional temporary living expenses and certain deductible expenses of selling your home and buying a new one. You deduct these expenses in 1988 if you itemize deductions on Schedule A (Form 1040).

Some of your moving expenses are subject to the *Dollar Limits*, discussed earlier. In addition, since your moving expenses were not reimbursed, you may only deduct 80% of your meals in 1988. You apply the 80% limit before you apply the $1,500 moving expense limitation on househunting and temporary quarters. The dollar limits are not separately applied to the expenses you deduct each year; they apply to the total expenses for that move.

You must show on your 1988 Form 3903 the amounts you deducted on your 1987 Form 3903 that were subject to the dollar limits. If you deducted $1,000 in 1987 for househunting and temporary living expenses, you may deduct up to $500 for these types of expenses in 1988, after you have applied the 80% rule to your meals.

In 1987, you deducted $1,000 for househunting and temporary living expenses. In 1988, you incurred $800 for temporary living expenses ($600 for lodging and $200 for meals), $3,500 to sell your old home, and $500 to buy a new home. Your deduction for temporary living expenses in 1988 is limited to $500. This is the lesser of $500 ($1,500 limitation minus the $1,000 you deducted in 1987) or $760 ($600 lodging plus $160 (80% of your $200 meal expense)).

Your total moving expense deduction in 1988 is limited to $2,000. This is the amount of your househunting, temporary living, and qualified real estate expenses ($4,500), subject to the $3,000 limitation, minus the deduction you took in 1987 ($1,000) that was subject to the same limitation.

You must show your 1987 deduction on your 1988 Form 3903 by writing "$1,000 deducted in 1987" above lines 20 and 22.

Example 2. In December 1987, your employer transferred you to another city, where you still work. You paid for all of your moving expenses in 1987. Your employer fully reimbursed you in 1988 for your moving expenses. This reimbursement is included in your 1988 Form W-2. You may deduct all of your allowable moving expenses in 1987 as an itemized deduction the year you paid them, or you may deduct them in 1988 (if you itemize deductions on Schedule A (Form 1040)), the year of reimbursement. In either case, your total deduction is the same.

Example 3. In December 1988, your employer transferred you to another city, where you still work. You started your move in 1988 and finished it in 1989. Your employer paid you a flat amount in December 1988 to move. This amount was included in your 1988 Form W-2. You paid your 1989 expenses by the due date for filing your 1988 return. You may deduct your 1988 moving expenses on your return for 1988 and your 1989 moving expenses on your return for 1989. Or, you may deduct all your allowable moving expenses on your return for 1988. In either case, your total deduction is the same, provided you itemize deductions on Schedule A (Form 1040).

29. Employee's Educational Expenses

Important Change for 1988

Educational assistance program. The exclusion for the first $5,250 of educational assistance provided by your employer under a qualified plan is no longer available. However, as this publication was being prepared for print, Congress was considering legislation that would extend the exclusion for education assistance programs, with some changes, through December 31, 1990. For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes* .

This chapter explains what work-related educational expenses qualify for deduction, how to report your expenses and any reimbursement you receive, and which forms and schedules to use to report your expenses and any reimbursement. If you have questions not answered here, see Publication 508, *Educational Expenses.*

Qualifying Education

You may deduct expenses you have for education, such as tuition, books, supplies, lab fees, and certain travel and transportation costs, even though the education may lead to a degree, if the education:

1) Is required by your employer, or by law or regulations, to keep your salary, status, or job (if the requirements serve a business purpose of your employer), or
2) Maintains or improves skills required in your present work.

You may not deduct expenses you have for education, even though the requirements listed above are met, if the education:

1) Is needed to meet the minimum educational requirements to qualify you in your trade or business, or
2) Is part of a program of study that can qualify you for a new trade or business, even if you have no plans to enter that trade or business.

See *Nonqualifying Education,* later.

Present work. You may deduct only expenses for education which relates to your present work. You may not deduct the cost of education taken to prepare you to return to work or to re-enter any previous business or profession.

Temporary absence from work. If you have qualifying educational expenses during a vacation, temporary leave, or other temporary absence from your job, you will be able to deduct the expenses if you return to the same kind of work. Ordinarily, if you stop work for a period of a year or less, and then you go back to the same kind of work, you are considered to have been temporarily absent from work.

Example. You quit your biology research job to take a one-year, full-time graduate course in biology. If you return to work in biology research after completing the course, and your expenses otherwise qualify, you may deduct them, even if you take a job with another employer.

Education Required by Employer

After you have the minimum education required to qualify for your job, your employer may require you to get more education to keep your present salary, status, or job. You may deduct the expenses of the additional education required by your employer, provided the education serves a business purpose and is not part of a program that will qualify you for a new trade or business.

You may deduct the expenses of education that is more than that required by your employer only if it maintains or improves skills needed in your job. See *Education to Maintain or Improve Skills,* later.

Example. You are a qualified teacher and are required by your employer to take an additional college course yearly to keep your teaching job. You take a course and pay for it yourself. You may deduct your expenses even if, as a result of the education, you eventually receive a master's degree and an increase in salary. You may not deduct expenses for more education than your employer requires unless you can show that they are expenses for education to improve or maintain skills needed in your job.

Education to Maintain or Improve Skills

You may deduct expenses for education to maintain or improve skills needed in your job. Ordinarily, this includes refresher courses or courses dealing with current developments, as well as academic or vocational courses. However, if the courses taken qualify you for a new trade or business, you may not deduct the expenses. See *Education to Qualify for a New Trade or Business,* later.

Example. You repair televisions, radios, and stereo sets. To keep up with the latest changes, you take special courses in radio and stereo service. Because these courses maintain and improve skills required in your work, you may deduct your expenses for this education.

Nonqualifying Education

You may not deduct the cost of education needed to meet the minimum educational requirements for a job or the cost of education that will qualify you for a new trade or business. The cost of this education is a personal expense, or a combination of personal and capital expenses, and not deductible even though it may maintain or improve skills needed in your work or may be required by your employer, or by law or regulations.

Education to Meet Minimum Requirements

You may not deduct expenses to meet the minimum educational requirements for qualification in your trade or business. The minimum education necessary is determined by such factors as the requirements of your employer, applicable law and regulations, and the standards of your profession or business.

The fact that you are already working does not show that you have met the minimum educational requirements of your trade or business.

Once you have met the minimum requirements that were in effect when you started your trade or business, you will be considered as continuing to meet them even if they are later changed.

Example 1. You are a full-time engineering student and have a part-time job as an engineer with a firm that will employ you full time as an engineer after you finish college. Although this education improves your skills in your present job, you may not deduct your expenses because you need the education to meet the minimum requirements of your new full-time job.

Example 2. You are an accountant and you have met the minimum educational requirements of your employer. Your employer later changes the minimum educational requirements and requires you to take college courses to keep your job. You may deduct the cost of these additional courses. They are not minimum requirements because you already have satisfied the initial minimum requirements. However, a new accountant coming into the firm would have to satisfy these new minimum requirements and would not be able to deduct those educational expenses.

Example 3. You have your own accounting practice. To improve your skills, you take several courses in tax accounting. You already have met the minimum educational requirements for the practice of accounting. These courses improve skills required in your business and are not part of a program of study that will qualify you for a new trade or business. You may deduct the cost of these courses.

Teachers and others employed by educational organizations. The minimum educational requirements for a person employed by a school means the minimum total college hours or the degree usually required of a person hired for that job.

If there are no such requirements, you will have met the minimum educational requirements when you become a faculty member.

Generally, you will be considered a faculty member when:

1) You have tenure,
2) Your years of service count toward obtaining tenure,
3) You have a vote in faculty decisions, or
4) Your school makes contributions for you to a retirement plan other than social security or a similar program.

Example. Your state law requires beginning school teachers to have a bachelor's degree, including ten professional education courses. In addition, to keep the job, a teacher must complete a fifth year of preparation within 10 years after being employed. However, if qualified teachers cannot be found, persons with only 3 years of college work may be hired on the condition that they obtain the degree and the required professional education courses within 3 years.

Under these facts, the bachelor's degree is considered the minimum educational requirement for qualification as a teacher in your state.

If you have all of the required education except the fifth year, you may deduct your expenses for the fifth year unless it qualifies you for a new trade or business. See *Education to Qualify for a New Trade or Business.*

If you have a bachelor's degree and only six professional education courses, you may deduct the cost of four more education courses because, for tax purposes, a bachelor's degree meets the minimum requirements for qualification as a teacher even if you do not have the required education courses.

If you are hired with only 3 years of college, the courses you take leading to a bachelor's degree, including those in education, are required to meet the minimum educational requirements for qualification as a teacher. You may not deduct their cost.

Education to Qualify for a New Trade or Business

You may not deduct expenses for education that is part of a program of study that qualifies you for a new trade or business. However, a change of duties is not considered a new trade or business if the new duties involve the same general work you presently do.

Example. You are a trust officer in a bank. Your employer requires you to get a law degree at your own expense. You register at a law school for the regular curriculum that leads to a law degree. Because this degree will qualify you for a business in which you were not previously qualified, you may not deduct your expenses.

Bar or CPA review course. You may not deduct expenses you have for a bar review or a CPA review course to prepare for the examination leading to admission to the bar or leading to certification as a certified public accountant. They are personal expenses.

Teachers. All teaching and related duties are considered the same general kind of work. A teacher whose duties change in the following ways has not changed to a new business:

1) Elementary school teacher to secondary school teacher,
2) Teacher of one subject, such as mathematics, to teacher of another subject, such as art,
3) Classroom teacher to guidance counselor, or
4) Classroom teacher to school administrator.

Example 1. You are a college professor with a master's degree. You take additional courses toward a doctorate required to qualify you for appointment as president of a junior college. You may deduct your educational expenses for the additional courses leading toward the doctorate because you have not entered a new trade or business.

Example 2. You hold a permanent teaching certificate in State A and, for several years, are employed as a teacher in that state. You move to State B and are promptly hired as a school teacher. You are required, however, to complete certain prescribed courses to get a permanent teaching certificate in State B. You may deduct the cost of the additional educational courses because the teaching position in State B involves the same general kind of work for which you qualified in State A. It is not a new trade or business.

Expenses of Education

If your education meets the requirements described earlier under *Qualifying Education,* you may be able to deduct the educational expenses you incur. These deductible expenses include amounts spent for tuition, books, supplies, laboratory fees, and similar items, and certain travel and transportation costs. Educational expenses also include the cost of correspondence courses, tutoring as well as formal training, and research and typing to prepare a paper as part of an educational program.

Educational expenses do not include expenses of a personal or capital nature. For example, you may not deduct the dollar value of vacation time or annual leave you take to attend classes. This amount is a personal expense.

Veterans. Educational assistance payments you receive from the Veterans Administration under a program that pays for educational expenses, such as tuition, books, and similar expenses, are tax exempt. To figure your deduction for expenses of education, you must reduce your educational expenses by the tax-exempt payments you receive from the Veterans Administration before completing Form 2106. The balance of the expenses exceeding your tax-exempt payments may be deductible as a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040).

If you receive Veterans Administration educational assistance payments under a program that pays for both living expenses and educational expenses, you must reduce your educational expenses by the part of the VA payments that are for educational expenses. Generally, 50% of the VA payments are subsistence. However, the subsistence payments of a married veteran are increased.

If all your educational expenses are otherwise deductible, find the amount to deduct by subtracting from your educational expenses the payments that are for the education.

If only part of your educational expenses are otherwise deductible, multiply your otherwise deductible educational expenses by a fraction. The numerator (top number) is the amount you received to pay for your education and the denominator (bottom number) is the total of your educational expenses. Subtract the result from your otherwise deductible educational expenses to find the amount to deduct.

Example 1. You have educational expenses of $1,000 for tuition, books, and similar expenses. The Veterans Administration pays you an educational assistance allowance of $780. Under this program, half of the payment is intended to be for living expenses and half for educational expenses. You may deduct $610 ($1,000 total expense minus $390 (½ of $780) paid by the Veterans Administration for education).

Example 2. If, in Example 1, you had total educational expenses of $1,500, of which $1,000 are otherwise deductible, you may deduct $740. This amount is figured by subtracting $260 ($1,000 × $390/$1,500 = $260) from $1,000.

Scholarships. Your deduction for educational expenses may not include any expenses for which you received a nontaxable scholarship.

Transportation Expenses

If your educational expenses are deductible, you may deduct local transportation expenses of going from work to school. Transportation expenses include the cost of travel by bus, subway, taxi, etc., or by the use of your own car. Parking and tolls are also included. Transportation expenses do not include the cost of travel, meals or lodging incurred while away from home overnight.

The amount you can deduct depends on where the school is located in relation to your place of work. If the school is located within the general locality where you work, you may deduct the expense of going from work to school. If you go home before going to school, your deduction is limited to the amount it would have cost to go directly from work to school. You may not deduct the cost of going home after school. See *Two places of work* in Chapter 19.

If the school is located beyond the general metropolitan area where you work and you return home each night, you may deduct the round-trip transportation costs to attend school. See *Temporary or minor assignment* in Chapter 19.

Example 1. You live and work in Camden, New Jersey, and go to New York City, which is beyond the general locality (metropolitan area) where you work, three times a week to attend night classes at a university. If your educational expenses are deductible, you may deduct your round-trip transportation expenses, including parking fees and tolls.

Example 2. You attend night classes at a college located in the same city as your office. Your educational expenses are deductible. You go directly to the college after work. You may deduct the cost of going from your office to the college.

If you use your car, you may deduct your actual expenses, or you may be able to use the standard mileage rate to figure the amount you can deduct. See *Car Expenses* in Chapter 19.

You may not deduct the cost of local transportation between your home and school on a nonworking day. This expense is a personal commuting expense.

Travel Expenses

If you travel away from home mainly to obtain education, the expenses for which are deductible, you may deduct your expenses for travel, meals, and lodging while away from home. However, you may not deduct expenses for personal activities such as sight-seeing, visiting, or entertaining.

If your travel away from home is mainly personal, you cannot deduct your expenses for travel, meals, and lodging. However, you may deduct your expenses for meals and lodging during the time you spend on deductible educational activities.

Whether a trip is mainly personal or mainly educational depends on the amount of time you spend on personal activities compared with the amount of time you spend on educational activities.

Example 1. You are in business in Newark, New Jersey. You went to Chicago to take a one-week course, the cost of which is deductible. While there, you took a sightseeing trip, entertained some personal friends, and took a side trip to Pleasantville for a day. You can deduct your transportation expenses to Chicago and back, but you cannot deduct your transportation expenses to Pleasantville. Only the meals and lodging connected with your educational activities can be included in your education expenses.

Example 2. You work in Boston and you went to a university in Michigan to take a course, the cost of which is deductible. You took one-fourth of a full course of study and spent the rest of your time on personal activities. Your trip is mainly personal. You may not deduct the cost of your transportation, but you may deduct one-fourth of the cost of your meals and lodging while attending the university.

Example 3. You work in Newark and you went to California to take a 2-week seminar, the cost of which is deductible. While there, you spent an additional 8 weeks on personal activities. These facts indicate that your main purpose was to take a vacation. You may not deduct your transportation expenses to and from California or your meals and lodging for the 8 weeks. You may deduct only your expenses for meals and lodging during the 2 weeks spent attending the seminar.

Meal expenses reimbursed by employer. If your educational expenses are deductible, you may claim a deduction (as an adjustment to gross income) for the total cost of meals that qualify as travel expenses related to your education, but only for those meals that were fully reimbursed by your employer. To figure your allowable meal expense, show the total amount of your meal expenses and related reimbursements on Form 2106.

80% limit. The deduction for business-related meals, including meals while traveling away from home to obtain your education, that were not reimbursed by your employer is limited to 80%. You may claim this amount as a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040), provided you are otherwise able to itemize your deductions. However, you must use Form 2106 to figure the amount of meal expense that is subject to the 80% limit before carrying the net amount of the deduction to Schedule A (Form 1040) and applying the 2% of adjusted gross income limit.

Qualified meeting. An expense for food or beverages incurred before 1989 that is part of a qualified meeting is not subject to the 80% limit. A convention, seminar, annual meeting, etc., is a qualified meeting if:

1) An expense for food or beverage is not separately stated from the other qualified meeting expenses such as attendance at speeches or other program activities;
2) At least 40 individuals attend;
3) Food and beverages are a part of the program that includes a ***bona fide*** speaker; and
4) More than 50% of the participants are away from home overnight.

If your educational expenses include expenses for travel, see Chapter 19 for more information on travel in and outside the United States.

Expenses of Travel as Education Not Deductible

You may not deduct the cost of travel that in itself is a form of education even though such travel expenses are directly related to your duties in your work or business.

Example. You are a French language teacher. While on sabbatical leave granted for travel, you traveled through France to improve your knowledge of the French language. You chose your itinerary and most of your activities to improve your French language skills. You may not deduct your travel expenses as educational expenses, even though your activities consisted mostly of visiting French schools and families, attending movies, plays, and similar activities.

Impairment-Related Work Expenses

You may be able to deduct certain expenses that you incur because of a handicap or disability in order for you to be able to work at your place of employment. Such impairment-related work expenses include, for example, the cost of attendant care expenses at your place of work, the costs of a reader, and any other impairment-related costs that you incur in connection with your place of employment or deductible educational expenses. These expenses also include impairment-related costs you incur while away from home on business to attend a seminar, for example. After figuring your deductible employee business expenses on Form 2106, you may claim any impairment-related work expenses as miscellaneous deductions on Schedule A (Form 1040), provided you are otherwise able to itemize your deductions. Deductible impairment-related work expenses, however, are not subject to the 2% of adjusted gross income limit. For information about reporting these expenses, see Chapter 30.

How to Report Educational Expenses and Reimbursements

The following discussions explain how to report your deductible educational expenses and any reimbursements or allowances you receive for your educational expenses.

Self-employed. If you are self-employed, deduct your educational expenses for tuition, books, laboratory fees, and similar items on line 29, Schedule C (Form 1040). Include your transportation and travel expenses for education on lines 9 and 26 of Schedule C.

Employee deductions and reimbursements. To claim a deduction for any employee business expenses, including educational expenses, you must file Form 1040 and include with it a ***Form 2106,*** *Employee Business Expenses.* On Form 2106, you will show the amount of your employee business expenses and the amount of any reimbursements or allowances for these expenses. Enter your educational expenses for tuition and books on line 4. However, if you accounted to your employer for your expenses and your expenses were equal to your reimbursement, the reimbursement was not included as wages on your Form W-2 (or as an allowance on a Form 1099) and you are claiming a deduction for unreimbursed expenses and not any meal, entertainment, travel or transportation expenses, you do not have to complete Form 2106. For more information about reporting other employee business expenses and reimbursements, see Chapter 19.

Schedule A (Form 1040). If your employee business expenses, including educational expenses, are either unreimbursed, or are more than the amount reimbursed by your employer, you generally must ***first use Form 2106*** to figure the amount of your business expenses to enter on line 20 of Schedule A (Form 1040). You must be able to itemize your deductions on Schedule A to claim this amount of your employee business expenses. These miscellaneous itemized deductions are subject to a 2% limit. The amount deductible is limited to the total of your miscellaneous deductions that are more than 2% of your adjusted gross income. This 2% limit is applied after all other deduction limits (such as the 80% limit on meal and entertainment expenses discussed in Chapter 19) are considered. The 2% limit, however, does not apply to ***impairment-related work expenses,*** described earlier. These expenses are claimed as other miscellaneous deductions on line 25 of Schedule A (Form 1040). See Chapter 30 for more information about the 2% limit.

Recordkeeping

You must keep proof to support your claim to a deduction as long as your income tax return can be examined. For specific information about keeping records of business expenses, see Chapter 19.

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30. Miscellaneous Deductions

Important Change for 1988

Expenses of a mutual fund. For tax years beginning after 1987, allocated investment expenses of a mutual fund are included among the miscellaneous deductions which are deductible only to the extent that their total exceeds 2% of your adjusted gross income. However, legislation pending in Congress may change this. See *Caution* under *Expenses to Produce Income; Other Expenses.*

You may deduct certain miscellaneous expenses on Schedule A (Form 1040). These expenses consist mainly of unreimbursed employee business expenses and expenses of producing taxable income. These deductions are in addition to the itemized deductions for medical and dental expenses, taxes, interest, charitable contributions, moving expenses, and casualty or theft losses.

The first part of this chapter contains lists of deductible expenses and nondeductible expenses. The lists are presented in the following order:

1) Deductions subject to the 2% limit,
2) Deductions not subject to the 2% limit, and
3) Nondeductible expenses.

The remaining parts of this chapter provide detailed information on the various deductible expenses and explain how they should be reported on your return.

Miscellaneous Deductions Subject to the 2% Limit

- Certain appraisal fees
- Certain legal fees
- Clerical help and office rent in caring for investments
- Custodial fees in connection with property held for producing income
- Dues to professional societies
- Employment-related education
- Fees to collect interest and dividends
- Hobby expenses, but generally not more than hobby income
- Investment counsel fees
- Laboratory breakage fees
- Liquidated damages paid to former employer for breach of employment contract
- Looking for a new job
- Malpractice insurance premiums
- Medical examinations required by employer
- Occupational taxes paid by an employee
- Part of home used regularly and exclusively in work
- Research expenses of a college professor
- Safe deposit box rental
- Small tools and supplies used in your work
- Subscriptions to professional journals and trade magazines related to your work
- Tax preparation fees
- Union dues and expenses
- Work clothes and uniforms

Note. The above deductions are subject to the 2% limit even if they are passed through to you from certain entities (for example, allocated investment expenses from a mutual fund).

Miscellaneous Deductions Not Subject to the 2% Limit

- Gambling losses to the extent of gambling winnings
- Federal estate tax on income in respect of a decedent
- Amortizable bond premium on bonds purchased before October 23, 1986
- Deduction for repayment of substantial amounts under a claim of right
- Unrecovered investment in pension
- Impairment-related work expenses of a handicapped individual

Nondeductible Expenses

- Adoption expenses for children with special needs
- Burial or funeral expenses
- Campaign expenses
- Capital expenses
- Certain fees and licenses
- Commuting expenses (but see *Transportation Expenses* in Chapter 19 if you work at two places in a day)
- Fines and penalties, such as parking tickets
- Gifts to influence legislation
- Health spa expenses
- Hobby losses
- Home repairs, insurance, and rent
- Illegal bribes and kickbacks
- Life insurance
- Losses from the sale of your home, furniture, personal car, etc.
- Lost or misplaced cash or property (but see *Mislaid or lost property* under *Theft* in Chapter 27)
- Lunches and meals while working late
- Personal legal expenses
- Personal, living, or family expenses
- Political contributions
- Professional accreditation fees
- Relief fund contributions for fellow employees
- Self-improvement expenses
- Stockholders' meeting, expenses of attending
- Tax-exempt income expenses
- Voluntary unemployment benefit fund contributions

Deductions Subject to the 2%-of-Adjusted-Gross-Income Limit

Most miscellaneous itemized deductions are deductible only to the extent the total of all of these deductions is more than 2% of your adjusted gross income. Miscellaneous deductions that are not subject to the limit are discussed later under *Deductions Not Subject to the 2% Limit.*

Deductions subject to the 2% limit are discussed in the two general categories that are shown on Schedule A (Form 1040): unreimbursed employee expenses, and other expenses. Your deduction is the excess of the total of the allowable deductions in these two categories over 2% of your adjusted gross income. The 2% limit is applied after any other deduction limit (such as the 80% limit on meals and entertainment) is applied. See *How to Report,* later, for more information on applying the limit.

Exception for performing artists. Although most unreimbursed employee expenses are subject to the 2% limit, there is an exception for unreimbursed business expenses of certain performing artists. See Publication 529, *Miscellaneous Deductions.*

Employee Business Expenses

If you are an employee, including an outside salesperson, you may deduct as an adjustment to income only the amount reimbursed by your employer for work-related business expenses. Any expenses that are not reimbursed or that are in excess of the amount reimbursed by your employer are deductible only as a miscellaneous deduction (subject to the 2% limit) on Schedule A (Form 1040).

Note. Except for those cases where you adequately account to your employer and your business expenses were equal to the reimbursements, you must complete Form 2106 and attach it to the Form 1040, if you claim a deduction for any employee business expenses. This applies to reimbursed expenses you claim as an adjustment to income on line 24, Form 1040 and to unreimbursed expenses you claim as a miscellaneous itemized deduction on line 20 of Schedule A (Form 1040).

However, if none of your employee business expenses are reimbursed by your employer and you are not claiming any meal, entertainment, travel, or transportation expenses, you do not have to complete Form 2106. Instead list your employee business expenses on line 20, Schedule A (Form 1040). See also *How to Report,* later.

Travel, Transportation, Meals, Entertainment, and Gift Expenses

If you are an employee and have ordinary and necessary travel, transportation, meal, entertainment, and gift expenses related to your work, you may be able to deduct these expenses on your income tax return.

For more information on travel, transportation, meals, entertainment, and gift expenses and reimbursements, see Chapter 19.

Work Clothes and Uniforms

You may deduct the cost and upkeep of special equipment or work clothes only if they are required as a condition of your employment and are not suitable for everyday use. To qualify for the deduction, ***both*** conditions must be met. It is not enough that your employer requires you to wear special clothing.

You may deduct the cost of uniforms you must wear if you are a professional ballplayer, fire fighter, police officer, letter carrier, nurse, jockey, or a civilian faculty member of a military school.

Armed forces uniforms. Generally, you may not deduct the cost of your uniforms if you are on full-time active duty in the armed forces. However, if you are an armed forces reservist, you may deduct the unreimbursed cost of your uniform if military regulations restrict you from wearing it except while on duty as a reservist. In figuring the deduction, you must reduce the cost by any nontaxable allowance you receive for these expenses.

If local military rules do not allow you to wear fatigue uniforms when you are off duty, you may be able to take a deduction. You may deduct the amount by which the cost of buying and keeping up these uniforms is more than the uniform allowance you receive.

Armed forces academies. If you are a student at an armed forces academy, you may not deduct the cost of your uniforms if they replace regular clothing. You may deduct the costs of insignia, shoulder boards, and related items.

Musicians and entertainers may deduct the cost of theatrical clothing and accessories if they are not suitable for ordinary use.

Painters may not deduct the cost of work clothing and standard work shoes even though the union requires that these be worn on the job.

Protective clothing. You may deduct the cost of protective clothing required in your work, such as safety shoes and glasses, hard hats, or work gloves.

Transportation employees' uniforms. If you are a transportation employee (air, rail, bus, etc.) you may deduct the cost of uniforms if they are not suitable for ordinary use.

Welders may not deduct the cost of work clothes worn solely at the request of the foreman.

Home Computers

You may be able to take an accelerated depreciation deduction and a section 179 deduction for a home computer provided you use the computer more than 50% of the time for business (in your work as an employee) and the computer was placed in your home for the convenience of your employer, as a condition of your employment, so that you can properly perform your duties as an employee. If you use the computer to produce income other than from a business, such as from investments, see *Expenses to Produce Income; Other Expenses,* later.

For more information about the rules and exceptions to the rules affecting the allowable deductions for a home computer, see Publication 529, *Miscellaneous Deductions.*

Reporting and substantiation requirements. To claim the deduction for your home computer, you must complete Part III of Form 4562, *Depreciation and Amortization* (which includes questions about the business use of your computer) and attach it to your tax return. Also, you must keep adequate records to prove your business use of the computer.

For more information about depreciation (including the section 179 deduction) and recordkeeping requirements, see Publication 534, *Depreciation.*

Union Dues and Expenses

You may deduct dues and initiation fees you pay for union membership.

Assessments for benefit payments to unemployed union members are deductible. However, you may not deduct the part of the assessments or contributions that provides funds for the payment of sick, accident, or death benefits. Also, you may not deduct contributions to a pension fund even if the union requires you to make such contributions.

Looking for a New Job

You may be able to deduct certain expenses you have in looking for a new job in your present occupation, even if you do not get a new job. You may not deduct these expenses if you are looking for a job in a new occupation, even if you get the job.

If you are unemployed, the kind of work you did for your past employer is your occupation. If there is a substantial break between the time of your past job and your looking for a new one, you may not deduct your expenses.

You may not deduct your expenses if you are seeking employment for the first time, even if you get the job.

Employment agency fees. If you pay employment agency fees in looking for a new job in your same occupation, you may deduct these expenses as an itemized deduction. If, in a later year, your employer pays you back for employment agency fees, you must include the amount you receive in gross income to the extent of your tax benefit in the earlier year (as explained under *Recoveries* in Publication 525, *Taxable and Nontaxable Income*). If your employer pays the fees directly to the employment agency and you were not responsible for them, you do not include them in your gross income.

Resumé. Amounts you spend for typing, printing, and mailing copies of a resumé to prospective employers are deductible as itemized deductions if you spent the amounts in looking for a new job in your present occupation.

Travel and transportation expenses. If you travel to an area and, while there, you look for a new job in your present occupation and also engage in personal activities, travel expenses to and from this area may be deductible as miscellaneous itemized deductions. To be deductible, the trip must be primarily to look for a new job. The amount of time you spend on personal activity compared to the amount of time you spend in looking for work is important in determining whether the trip is primarily personal. See *Travel Expenses* in Chapter 19 for more information.

Even if the travel expenses to and from an area are not deductible, the expenses of looking for a new job in your present occupation, while in the area, are deductible.

Repayment of Income Aid Payment

If you repay a lump-sum income aid payment that you received and included in income in an earlier year, you may deduct the repayment on Schedule A (Form 1040). An "income aid payment" is one that is received under an employer's plan to aid employees who lose their jobs due to lack of work.

Using Your Home In Your Work

If you are not a self-employed person and you use a part of your home ***regularly and exclusively*** for business purposes, you may be able to deduct a part of the operating and depreciation expenses on your home.

Use tests. You may deduct certain expenses for operating a part of your home only if that part of your home is used ***regularly and exclusively*** as:

1) Your principal place of business for any trade or business in which you engage,
2) A place to meet or deal with your patients, clients, or customers in the normal course of your trade or business, or
3) A separate structure that is used in your trade or business and is not attached to your house or residence.

In addition, if the regular and exclusive business use is for your work as an employee, the use must be ***for the convenience of your employer*** and not just appropriate and helpful in your job.

You may have a principal place of business for ***each*** trade or business in which you engage. For example, as a teacher, your principal place of business for teaching is the school. If you also engage in a retail sales business and use part of your home as your principal place of business for retail selling, expenses for this business use of your home may be deductible.

The business use of your home. You cannot deduct any operating or depreciation expenses for the use of your home if the use is for a profit-seeking activity that is not a trade or business. For example, you cannot deduct these expenses if you use a part of your home, even though regularly and exclusively, to read financial periodicals and reports, clip bond coupons, and perform similar investment activities on your own behalf, because these activities are not a trade or business.

The use of a part of your home for ***both personal and business purposes*** does not meet the exclusive use test and you may not deduct expenses for business use, except those for the use of your home as a day-care center. If, for example, you use the den of your home to write legal briefs, prepare tax returns, or perform similar activities, as well as for personal purposes, you may not deduct any expenses for the business use of that part of your home.

Use of your home as a day-care center. The exclusive use requirement does not apply when you regularly use your home, or any part of your home, in your business of providing day-care services to children, handicapped persons, or the elderly.

Storage use. You may deduct certain business expenses for the part of your home you regularly use to store goods you sell at retail or wholesale in your trade or business. Your home must be the only fixed location of that business. This storage space can have other uses, but the space must be a specific area.

Percentage of business use. To figure the percentage of your home used for business, compare the square feet of space used for business to the total square feet in your home. Or, if the rooms in your home are approximately the same size, you may compare the number of rooms used for business to the total number of rooms in your home. Generally, you figure the business part of your expenses by applying the percentage to the total of each expense.

If you use part of your home as a day-care center and you make any use of that part for personal purposes, you must also figure what percentage of available time you actually use it for business. You then apply the business percentage of time to the business part of your expenses.

You may not deduct any part of personal expenses that are for family household purposes.

The cost of repairs. You may deduct the cost of painting and repairing rooms that are used only for business purposes. You may not deduct the costs of painting and repairing rooms used for other purposes.

However, you may deduct a part of the cost of painting the outside of your home or repairing the roof based on the percentage of business use. You may not deduct expenses for lawn care and landscaping.

Depreciation. You may deduct depreciation on the part of your home used for business.

Limit on deduction for business use. The deduction for the business use of your home is limited to the gross income from that business use. This limit is discussed in Publication 587, *Business Use of Your Home*.

Home leased to employer. If you are an employee and lease a portion of your home to your employer, you cannot take a deduction for expenses that would otherwise be allowable as home office expenses during the time you use your home while performing services as an employee for your employer.

How to report. If you are an employee, you generally report your expenses for the business use of your home (insurance, maintenance, utilities, depreciation) on Form 2106. If business use of the home expenses were your only employee business expenses in 1988, you do not have to fill out Form 2106. In this case, enter your total expenses directly on line 20 of your Schedule A. Employee business expenses for which you are reimbursed or for which you receive an allowance are deducted as an adjustment to income.

If you do not receive any reimbursement for the business use of your home expenses or if your expenses exceed reimbursement, you can deduct the expenses only if you itemize deductions on Schedule A. You deduct the expenses for mortgage interest, real estate taxes, and casualty losses on the appropriate lines on Schedule A. You enter the rest of your office-in-the-home expenses, as well as any other employee business expenses, as miscellaneous itemized deductions on line 20 of Schedule A, subject to the 2% of adjusted gross income limit.

You may deduct the remaining real estate taxes, under *Taxes You Paid*, mortgage interest, under *Interest You Paid*, or casualty losses, under *Casualty and Theft Losses*, on the appropriate lines on your Schedule A (Form 1040).

If you are self-employed, see Publication 587, for how to report your expenses for the business use of your home.

Records. You should keep records that will give the information needed to figure the deduction according to these rules. You should keep cancelled checks and receipts of the expenses paid to prove the deductions you claim.

For more information on using your home in your work and how to compute your allowable deduction, see Publication 587.

Expenses to Produce Income; Other Expenses

You may deduct certain other expenses as miscellaneous itemized deductions subject to the 2% of adjusted gross income limit. They are listed on line 21 of Schedule A (Form 1040). These are expenses you pay:

1) To produce or collect income,
2) To manage, conserve, or maintain property held for producing income, or
3) To determine, contest, pay, or claim a refund of any tax.

The expenses must be directly related to the income or income-producing property and the income must be taxable to you.

Indirect deductions of pass-through entities (partnerships, S corporations, and mutual funds). Deductions of pass-through entities are passed through to the partners or shareholders. If the deductions are miscellaneous itemized deductions, they are generally subject to the 2% limit.

Information returns. You should receive information returns from these entities. Mutual funds issue Form 1099–DIV, which shows gross dividends and other distributions in Box 1, and investment expenses in Box 2. Partnerships and S corporations issue Schedule K–1, which lists the items and amounts you must report, and identifies the tax return schedules and lines to use.

Example. If you are a member of an investment club partnership that is formed solely to invest in securities, and its income is solely from taxable dividends, interest, and gains from sales of securities, you may deduct your share of the partnership's operating expenses as miscellaneous itemized deductions subject to the 2% limit. However, if the investment club partnership has investments that also produce nontaxable income, you may not deduct your share of the partnership's expenses that produce the nontaxable income. You should receive a copy of Schedule K–1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.*, which lists the items and amounts you must report, and identifies the tax return schedules and lines to use.

Caution: As this publication was being prepared for print, Congress was considering legislation that would exempt "publicly offered" mutual funds from allocating investment expenses.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Clerical help and office rent. You may deduct office expenses, such as rent, clerical help, telephone, etc., that you incur in connection with your investments and collecting the taxable income on them.

Custodian fees and service charges to subscribers in a dividend reinvestment plan are deductible. These are for services including:

1) Holding shares acquired through a plan,
2) Collecting and reinvesting cash dividends, and
3) Keeping individual records and providing detailed statements of accounts.

Service fees. You may deduct fees you pay to a broker, a bank, a trustee, or similar agent to collect your taxable bond interest or dividends on shares of stock. But you may not deduct a fee you pay to a broker to buy investment property, such as stocks or bonds. You must add the fee to the cost of the property.

Home computer. You may deduct depreciation on your home computer to the extent you use it for the production of income (for example, managing your investments that produce taxable income). However, certain limits may apply, as explained under *Partial Business Use of Listed Property* in Publication 534. If you work as an employee and use the computer in that work, see *Home Computers*, earlier, under *Employee Business Expenses*.

Investment counsel fees paid for managing your investments are deductible if they relate to investments that produce taxable income.

Trustee's administrative fees that are billed separately and that you paid in connection with your individual retirement arrangement (IRA) are deductible, provided that they are ordinary and necessary. These fees do not include capital expenditures (such as brokers' fees that you must add to the cost of securities you buy through brokers). These fees also do not include disguised IRA contributions. These trustee's fees are not subject to the annual dollar limit on contributions you can make to an IRA. Deduct them on line 21, Schedule A (Form 1040), not with your IRA deduction on line 25a or b, Form 1040. For more information about IRAs, see Publication 590, *Individual Retirement Arrangements (IRAs)*.

Legal expenses that you have to produce taxable income usually are deductible. You may have legal expenses that are related to either doing your job or keeping your job.

You may deduct legal expenses for tax advice related to a divorce if the bill specifies how much is for tax advice and if the amount is determined in a reasonable way. You also may have legal expenses to collect taxable alimony. Because you pay tax on this income, you may deduct your legal costs as an expense necessary to produce taxable income.

Safe deposit box rent is deductible if you use the box to store taxable income-producing stocks, bonds, or investment-related papers and documents. You may not deduct the rent if you use the box only for jewelry or other personal items or for tax-exempt securities.

Repayments of social security benefits. For information on how to deduct your repayments of certain social security benefits, see Publication 915, *Social Security Benefits and Equivalent Railroad Retirement Benefits*.

Appraisal fees are deductible if you pay them to determine the amount of a casualty loss or the fair market value of donated property.

Tax preparation fees, usually are deductible in the year you pay them. Thus, you may deduct on your 1988 return fees paid in 1988 for preparing your 1987 return.

Deductions Not Subject to the 2% Limit

The following expenses are deductible as miscellaneous itemized deductions, but not subject to the 2% limit. They are reported on line 25, Schedule A (Form 1040).

Federal estate tax on income in respect of a decedent. You may deduct the federal estate tax attributable to income in respect of a decedent that is ordinary income and that you as a beneficiary include in your gross income. Income in respect of the decedent is gross income that the decedent had a right to receive, could have received had death not occurred, and that was not properly includible in the decedent's final income tax return. See Chapter 4 for more information.

Amortizable bond premium. Bond premium is the amount you pay for bonds that is greater than the face value of the bonds. You may elect to amortize the premium on taxable bonds. Miscellaneous itemized deductions not subject to the 2% limit would include only the premium on bonds purchased before October

23, 1986. For bonds purchased after October 22, 1986, the amount would be reported as investment interest. For more information see Chapter 25.

Caution: As this publication was being prepared for print, Congress was considering legislation that would treat amortizable bond premium on a taxable bond acquired after December 31, 1987, as an offset to interest income on the bond, rather than as a separate interest deduction item subject to the investment interest limitations. This treatment could also be elected on bonds acquired after October 22, 1986.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Gambling losses to the extent of gambling winnings. You may not deduct more than the gambling winnings you report on line 22, Form 1040. You must keep an accurate diary or similar record of your losses and winnings and you must be able to prove the amounts of your winnings and losses by receipt, ticket, or statement.

Unrecovered investment in pension. If a retiree had contributed to the cost of a pension or annuity, a part of each payment received can be excluded from income as a tax-free return of the retiree's investment. If the retiree dies before the entire investment is returned, any unrecovered investment is allowed as a deduction on the retiree's final return. See Chapter 11 for more information.

Repayments under claim of right. If you had to repay more than $3,000 that you included in income in an earlier year because at the time you thought you had an unrestricted right to it, you may be able to deduct the amount you repaid. See Chapter 13 for more information.

Impairment-related work expenses. If you have a physical or mental disability that limits your being employed, or substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, your impairment-related work expenses are deductible.

Impairment-related work expenses are expenses for attendant care services at your place of work and other expenses in connection with your place of employment which are necessary for you to be able to work and which are ordinary and necessary in your kind of work.

If you qualify for impairment-related work expenses, you should complete Form 2106. Enter the amount from line 17 of Form 2106 on Schedule A (Form 1040), line 25, instead of Schedule A, line 20. To the extent you are reimbursed or receive an allowance for your impairment-related work expenses, deduct these expenses as an adjustment to income. Also see the *Instructions for Form 2106.*

How to Report

You must itemize deductions to be able to claim miscellaneous deductions on Schedule A (Form 1040).

If you have unreimbursed employee business expenses, generally you must first complete Form 2106. You should carry over the amount on line 17 of Form 2106 to Schedule A (Form 1040), line 20. Attach the completed Form 2106 to Form 1040.

Any other miscellaneous deductions subject to the 2% limit should be claimed on line 21 of Schedule A (Form 1040). However, if none of your employee business expenses are reimbursed by your employer and you are not claiming any meal, entertainment, travel, or transportation expenses, you do not have to complete Form 2106. Instead, list your employee business expenses on line 20, Schedule A (Form 1040).

If you have miscellaneous deductions ***not*** subject to the 2% limit, you should claim these amounts on line 25 of Schedule A (Form 1040).

Nondeductible Expenses

The following expenses are not deductible.

Adoption expenses you paid for the legal adoption of a child with special needs are not deductible.

Campaign expenses of a candidate for any office, even if the candidate is running for reelection to the office, are not deductible. These include qualification and registration fees for primary elections.

Legal fees paid to defend charges that arise from participation in a political campaign are not deductible.

Check-writing fees. If you have a personal checking account, you may not deduct fees charged by the bank for the privilege of writing checks, even if the account is an interest-bearing one.

Commuting expenses to and from work are not deductible. If you haul tools, instruments, etc., in your car to and from work, see Chapter 19.

Fees and licenses. You may not deduct amounts paid for car licenses, marriage licenses, dog tags, etc.

Fines or penalties you pay to a governmental unit for violating a law are not deductible. Examples include parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.

Gifts or amounts spent to influence the general public on legislative matters, elections, or referenda are not deductible.

Health spa expenses are not deductible, even if there is a job requirement to stay in excellent physical condition, such as might be required of a law enforcement officer.

Insurance premiums that you pay or that are placed in escrow for your home, such as fire and liability or mortgage insurance, are not deductible. Premiums you pay on your life insurance are not deductible unless the policy is assigned for alimony.

Lunches or meals while working late, except while traveling away from home, are not deductible.

Personal legal expenses, such as the following, are not deductible:

Defense of a breach of promise suit,

Defense of civil or criminal charges resulting from a personal relationship,

Defense of property claims in a divorce,

Preparation of a will, and

Property settlement in a divorce.

In some cases legal expenses are part of the basis of property. See Chapter 15.

Political contributions. You may not deduct contributions made to a political candidate, a campaign committee, or a newsletter fund.

Professional accreditation fees, such as the following, are not deductible:

Accounting certificate fees paid for the initial right to practice accounting,

Bar exam fees and incidental expenses in securing admission to the bar, and

Medical and dental license fees paid to get initial licensing.

Self-improvement. You may not deduct expenses for increasing your personal prestige or establishing your professional reputation.

Stockholders' meetings. You may not deduct transportation and other expenses you pay to attend stockholders' meetings of companies in which you own stock but have no other interest. You may not deduct these expenses even if you are attending the meeting to get information that would be useful in making future investments.

Tax-exempt income. You may not deduct expenses to produce tax-exempt income. You may not deduct interest on a debt incurred or continued to buy or carry tax-exempt securities.

If you have expenses to produce both taxable and tax-exempt income, but you cannot identify the expenses that produce each type of income, you must divide them to determine the amount that you may deduct.

Example. During the year you received taxable interest of $4,800 and tax-exempt interest of $1,200. You had expenses of $500 during the year to earn this income. If you cannot specifically identify the amount of each expense item for each income item, you must allocate 80% ($4,800/$6,000) of the expense to taxable interest and 20% ($1,200/$6,000) to tax-exempt interest. You may deduct, subject to the 2% limit, expenses of $400.

Voluntary unemployment benefit fund contributions you make to a union fund or a private fund are not deductible. If you make contributions to a state unemployment fund, see *Income Taxes* in Chapter 24.

Part VI
Figuring Your Taxes and Credits

The chapters in this part explain how to figure your tax and how to figure the tax of certain children who have more than $1,000 of investment income. They also discuss some of the tax rules that let you directly lower the amount of tax you must pay.

Tax credits, unlike deductions, are subtracted directly from your tax, and therefore reduce your tax dollar for dollar. There are tax credits for the elderly or for the disabled, for the expense of having your child or disabled dependent cared for so that you can work, and for other kinds of expenses.

31. How to Figure Your Tax

This chapter explains the steps you need to take to figure your taxes, whether you file Form 1040EZ, Form 1040A, or Form 1040. It also helps you choose whether you should itemize deductions or take the standard deduction. In addition, it covers the alternative minimum tax (Form 6251).

How you figure your tax depends on which form you use and whether you itemize your deductions.

Note: Previously, taxable amounts received from scholarships or fellowship grants could be reported only on Form 1040. Beginning in 1988, these taxable amounts can also be reported on Form 1040EZ (line 1) and Form 1040A (line 7).

Form 1040EZ

If you file Form 1040EZ, you must figure your taxable income before you can find your tax.

Taxable income (line 7, Form 1040EZ) is the total of your wages, salaries, tips, scholarships or fellowship grants to the extent taxable, and interest, minus your standard deduction (line 4) and the deduction for your personal exemption (line 6). Your standard deduction is $3,000, unless you can be claimed as a dependent by another taxpayer. (See *Standard Deduction for Dependents* in Chapter 22.) The deduction for your exemption is $1,950, which you enter on line 6. However, if you can be claimed as a dependent by another taxpayer, your personal exemption is zero.

Tax withheld. After you have figured your taxable income, you enter the total of your Federal income tax withheld on line 8. This amount is shown on your Form(s) W–2.

Also include on line 8 any excess social security or railroad retirement tax withheld. See Chapter 35 for a discussion of excess withholding.

To find your tax, use the Tax Table at the back of this publication or in the instructions for Forms 1040A and 1040EZ. Find the income line that includes your taxable income shown on line 7 of your Form 1040EZ. Next, find the column for single and read down the column. The amount shown where the income line and filing status column (single) meet is your tax. Enter it on line 9.

Refund or amount you owe. If line 8 is larger than line 9, subtract line 9 from line 8 and enter the result on line 10. This is the amount of your refund. For information on refunds, see *Refunds*, in Chapter 1.

If line 9 is larger than line 8, subtract line 8 from line 9 and enter the result on line 11. This is the amount you owe. For information on how to pay, see *Amount You Owe*, in Chapter 1.

A filled-in Form 1040EZ is shown in Chapter 36.

Form 1040A

If you file Form 1040A, you must find your adjusted gross income and your taxable income before you can figure your tax.

Adjusted gross income (line 13, Form 1040A) is your total income (line 11) minus your IRA deduction, and your spouse's IRA deduction if you file a joint return. You figure your deduction by completing the worksheet in the instructions for Form 1040A. Also see Chapter 20.

Taxable income (line 19) is your adjusted gross income (line 14) minus your standard deduction (line 16) and the deduction for your exemptions (line 18). For information on your standard deduction, see *Standard Deduction*, later, and Chapter 22. To figure the deduction for your exemptions, multiply $1,950 by the number of exemptions claimed on line 6e.

Tax, credits, and payments. To find your tax, use the Tax Table at the back of this publication or in the instructions for your Form 1040A.

Caution: If you were under age 14 at the end of 1988 and had more than $1,000 of investment income, you cannot use the Tax Table. Instead, you must check the box above line 20 and use Form 8615, *Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000,* to compute your tax.

Tax. Find the income line that includes your taxable income shown on line 19. Next, find the column heading that describes your filing status and read down the column. The amount shown where the income line and filing status column meet is your tax. Enter it on line 20, and check the box marked "Tax Table."

Credits. After you have figured your tax, figure any credit for child and dependent care expenses (line 21) you may have. If you claim the credit for child and dependent care expenses, you must complete Part I of Schedule 1 (Form 1040A) and attach it to your return. Subtract your credit for child and dependent care from your tax on line 20 to get your total tax on line 22. For information on the credit for child and dependent care expenses, see Chapter 33.

Payments. Your next step is to figure your total payments. On line 23a, you enter the total Federal income tax withheld from your pay. This amount is shown in Box 9 of your Form(s) W–2. Also include on line 23a any excess social security or railroad retirement tax withheld. See Chapter 35 for a discussion of excess withholding.

On line 23b, you enter your earned income credit. Figure the amount of your earned income credit by completing either the worksheet in the instructions for Form 1040A or the worksheet in Chapter 35. For information on the earned income credit, see Chapter 35. Add lines 23a and 23b together and enter this total on line 24. These are your total payments.

Refund or amount you owe. If line 24 is larger than line 22, subtract line 22 from line 24 and enter the result on line 25. This is the amount of your refund. For information on refunds, see *Refunds*, in Chapter 1.

If line 22 is larger than line 24, subtract line 24 from line 22 and enter the result on line 26. This is the amount you owe. For information on how to pay, see *Amount You Owe*, in Chapter 1.

A filled-in Form 1040A is shown in Chapter 37.

Form 1040

If you file Form 1040, you must find your adjusted gross income and taxable income before you can figure your tax.

Adjusted Gross Income

Adjusted gross income (line 31, Form 1040) is your total income (line 23) minus any adjustments from the following:

- Reimbursed employee business expenses including travel, meals and lodging away from home, and local transportation expenses. See Chapters 19 and 29.
- IRA deduction for you (line 25a), and for your spouse (line 25b). See Chapter 20.
- Keogh retirement plan and self-employed SEP deduction. See Publication 560, *Self-Employed Retirement Plans.*
- Penalty on early withdrawal of savings. See Chapter 8.
- Alimony paid. You must show the recipient's last name and social security number in the spaces provided on line 29. See Chapter 21.
- Certain expenses of qualified performing artists. See Chapter 30.
- Self-employed health insurance deduction. See Chapter 23.
- Foreign housing deduction. See Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad.*
- Amortization of the costs of forestation or reforestation if you do not have to file Schedule C or Schedule F. See Publication 535, *Business Expenses.*
- Certain required repayments of supplemental unemployment benefits. See Chapter 6.

Taxable Income

The amount of your taxable income (line 37) depends upon whether you itemize your deductions on Schedule A (Form 1040) or take the standard deduction.

Itemizing Your Deductions

You generally have a choice between itemizing your deductions (such as medical expenses, taxes, interest, and casualty losses) on Schedule A (Form 1040) or taking a standard deduction amount, whichever allows you to pay less tax.

You may benefit from itemizing your deductions on Schedule A if you:

- Do not qualify for the standard deduction, or the amount you can claim is limited,
- Had large uninsured medical and dental expenses during the year,
- Paid interest and taxes,
- Had large unreimbursed employee business expenses or other miscellaneous deductions,
- Had unreimbursed moving expenses,
- Had large casualty or theft losses not covered by insurance,
- Made large contributions to qualified charities, and
- Have total itemized deductions that are more than the highest standard deduction amount to which you are otherwise entitled.

Some taxpayers itemize deductions because they do not qualify for the standard deduction or the amount they qualify for is limited (see Chapter 22). Other taxpayers itemize their deductions because they will save money.

If you decide to itemize your deductions, complete and attach Schedule A and enter the amount from Schedule A, line 26, on Form 1040, line 34. Be sure to attach Schedule A to your return.

If you itemize your deductions, your taxable income (line 37 of Form 1040), is your adjusted gross income (line 32), minus your itemized deductions (line 34) and your exemptions (line 36).

Changing your mind. If you do not itemize your deductions and later find you should have itemized—or if you itemize and later find you should not have—you may change your return by filing Form 1040X, *Amended U.S. Individual Income Tax Return.*

If you are married and file separate returns, you may change to taking itemized deductions or the standard deduction only if you and your spouse both make the same changes. Both of you must consent in writing to assessment for any additional tax either one may owe as a result of the change.

If you and your spouse file separate returns, you should use the method that gives you the lowest total tax, even though one of you may pay more tax. You *both must use the same method* of claiming deductions. If one itemizes deductions, the other should itemize deductions since he or she will not qualify for the standard deduction.

Standard Deduction

The standard deduction replaces the zero bracket amount used in prior years and reduces the amount of your income that is taxed. As a result, many taxpayers no longer have to itemize their deductions to reduce their tax. The standard deduction, which depends on your filing status and whether you are 65 or over or blind, is not built into the Tax Table or the Tax Rate Schedules but is figured separately.

65 or over or blind. If you are 65 or over or blind in 1988, you are entitled to a standard deduction amount which is more than the amount for taxpayers under 65 and not blind. This increased deduction replaces the additional exemptions allowed in prior years for age and blindness. For information on who qualifies for the higher standard deduction amount for age and blindness, see Chapter 22. The standard deduction amounts are given in the *1988 Standard Deduction Table* later in this chapter.

Special rules. Your standard deduction is **zero** if:

- Your spouse itemizes deductions on a separate return,
- You are a dual-status or nonresident alien, or
- You have a short tax year.

If you can be claimed as a dependent on another person's return, your standard deduction may be limited. See *Standard Deduction for Dependents,* in Chapter 22.

Standard deduction amount. If you do not fall under the *Special rules* above, use the *1988 Standard Deduction Table* later in this chapter to find your standard deduction amount.

If you decide to take the standard deduction, show the correct amount on line 34 of Form 1040.

If you take the standard deduction, your taxable income (line 37 of Form 1040) is your adjusted gross income (line 32), minus your standard deduction (line 34) and your exemptions (line 36).

Tax, Credits, and Payments

Most people use the Tax Table to figure their tax. However, you must use the Tax Rate Schedules to figure your tax if your taxable income is $50,000 or more.

Tax Table

The Tax Table is at the back of this publication and in the instructions for Form 1040.

To find your tax, read down the income column to the line that includes your taxable income as shown on line 37, Form 1040. Then read across the line to the column heading that describes your filing status. The amount shown where the income line and filing status column meet is your tax. Enter it on line 38, Form 1040, and check the box marked *Tax Table.*

Tax Rate Schedules

If your taxable income (line 37) is $50,000 or more, you must figure your tax by using Tax Rate Schedule X, Y-1, Y-2, or Z.

Each schedule has two basic tax rates: 15% and 28%. However, taxable income within a certain higher income range will be subject to an additional 5% tax that phases out the benefit of the 15% rate. If your taxable income is in the range for your filing status shown in the following table, the part of your income that is within the range is taxed at a 33% rate (28% + 5%):

Filing Status	Taxable Income Subject to Additional 5% Tax More Than	 But Not More Than
Married Filing Jointly or Qualifying Widow(er)	$71,900	$149,250
Single	43,150	89,560
Married Filing Separately	35,950	113,300
Head of Household	61,650	123,790

Example. You are a single taxpayer with 1988 taxable income of $50,000. Because your taxable income is in the $43,150–$89,560 range for your filing status, $6,850 ($50,000–$43,150) is subject to the additional 5% tax, increasing the rate from 28% to 33%. Using Tax Rate Schedule X, you figure your tax as follows:

Taxable Income Brackets	Tax Rates		Tax
$ 17,850	x 15%	=	$ 2,677.50
25,300	x 28%	=	7,084.00
6,850	x 33%	=	2,260.50
Total Tax			**$12,022.00**

If you have taxable income of more than $89,560, the part of your income in excess of that amount will also be subject to an additional 5% tax that phases out the deduction for your personal exemption. You figure your tax on the worksheet in the tax rate schedules. See Chapter 3 for more information.

The tax rate schedules are at the back of this publication and in the Form 1040 instructions. Enter your tax on line 38, Form 1040, and check the box marked *Tax Rate Schedules.*

Form 8615

If you were under age 14 at the end of 1988 and had more than $1,000 of investment income, you must compute your tax using Form 8615, *Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000.* For more information on this computation, see Chapter 32.

Additional Taxes

If you owe any of the taxes listed on line 39 (Form 1040), attach the appropriate form. On line 39, check the box that applies to you and enter the amount of additional taxes.

Credits

After you have figured your tax and entered the total of lines 38 and 39 on line 40 (Form 1040), you figure your credits and enter them on lines 41 through 46. Enter the total on line 47.

Credit for child and dependent care expenses. Use Form 2441, *Credit for Child and Dependent Care Expenses,* to compute your credit and enter the credit on line 41. Information on this credit is in Chapter 33.

Credit for the elderly or the disabled. Enter on line 42 the amount of this credit, which you compute on Schedule R. See Chapter 34 for more information.

Foreign tax credit. Enter on line 43 (Form 1040) the amount of foreign tax credit you computed on Form 1116. Foreign tax credit is discussed in Publication 514, *Foreign Tax Credit for Individuals.*

1988 Standard Deduction Table

Caution. This table does not apply to taxpayers who can be claimed as dependents. See Chapter 22.

STEP 1. Check the correct number of boxes below.

You	65 or older ☐	Blind ☐
Your Spouse	65 or older ☐	Blind ☐

Total number of boxes you checked .... ________

STEP 2. Find your standard deduction.

If your filing status is:	and number of boxes you checked in Step 1 above are:	your standard deduction is:
Single	0	$3,000
	1	3,750
	2	4,500
Married filing jointly	0	$5,000
	1	5,600
	2	6,200
	3	6,800
	4	7,400
Married filing separately *	0	$2,500
	1	3,100
	2	3,700
	3	4,300
	4	4,900
Head of household	0	$4,400
	1	5,150
	2	5,900
Qualifying widow(er)	0	$5,000
	1	5,600
	2	6,200

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* If your spouse itemizes deductions on a separate return, your standard deduction is zero.

General business credit. Enter on line 44 (Form 1040) any general business credits you may have and check the appropriate box to identify which form you are attaching. See Publication 572, *General Business Credit*, for a discussion of business credits.

Credit for prior year minimum tax. Complete Form 8801, *Credit for Prior Year Minimum Tax*, if you paid alternative minimum tax in 1987 on deferred preference items. Enter the amount of the credit on line 45 (Form 1040) and attach Form 8801 to your tax return. For information on this new credit, see Publication 909, *Alternative Minimum Tax for Individuals*.

Other Taxes

If you owe any of the taxes shown on lines 48 through 52, complete the lines that apply to you and enter your total tax (the sum of lines 47 through 52) on line 53.

Self-employment tax. If you (or your spouse if you file a joint return) have net earnings of $400 or more from self-employment, complete Schedule SE and show any tax you owe on line 48 (Form 1040). See Publication 533, *Self-Employment Tax*, for more information.

Alternative minimum tax. Use Form 6251 to see if you owe any alternative minimum tax. Enter your result on line 49 (Form 1040). The computation of this tax is discussed later in this chapter and in Publication 909.

Recapture taxes. If you are required to compute the recapture of investment tax credit on Form 4255 or low-income housing credit on Form 8611, enter the amount on line 50 (Form 1040) and check the appropriate box. For more information, see Publication 572.

Social security tax on tip income not reported to employer. Attach Form 4137, *Computation of Social Security Tax on Unreported Tip Income*, and show on line 51 (Form 1040) the tax due on tip income you did not report to your employer. See Chapter 7 for more information.

Tax on IRAs and qualified retirement plans. If you had an excess contribution to, early distribution from, or excess accumulation in your individual retirement arrangement (IRA), you must complete Form 5329, *Return for Individual Retirement Arrangement and Qualified Retirement Plans Taxes*, and show the result on line 52 (Form 1040). See Chapter 20 for more information.

Payments

Once you have your total tax (line 53), you must figure your total payments. On line 54, enter your Federal income tax withheld. This amount is shown on your Forms W-2, W-2G, W-2P, and 1099-R. If you made estimated tax payments in 1988, you enter the total of these payments on line 55. Also enter on line 55 any overpayment you asked to be applied from your 1987 return to your 1988 return. Complete lines 56 through 60, if they apply, and enter your total payments on line 61.

Refund or Amount You Owe

After you have your total tax (line 53) and your total payments (line 61), you must determine if you are due a tax refund or if you owe additional tax.

Refund

If the amount on line 61 is larger than the amount on line 53, subtract line 53 from line 61 and enter the result on line 62. This is the amount of tax you have overpaid. If you want the entire amount refunded to you, enter the amount from line 62 on line 63. If you want all or part of your overpayment applied to your 1989 estimated tax, you must complete both line 63 and line 64. For information on refunds, see *Refunds*, in Chapter 1.

Amount You Owe

If the amount on line 53 is larger than the amount on line 61, subtract line 61 from line 53 and enter the result on line 65. This is the amount of tax you owe. For information on how to pay, see *Amount You Owe*, in Chapter 1.

Alternative Minimum Tax

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. Taxpayers who benefit from these laws have to pay at least a minimum amount of tax through a special tax.

This special tax is called the ***alternative minimum tax.*** This tax has been broadened to include more taxpayers who pay little or no income tax, and strengthened to make sure that all taxpayers with economic income pay tax.

Caution: As this publication was being prepared for print, Congress was considering legislation that would:

1) Not allow the deduction for personal exemptions in figuring the alternative minimum tax, and
2) Require the inclusion of the parent's alternative minimum taxable income when figuring the alternative minimum tax of a child under age 14 with more than $1,000 of unearned income.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes*.

Alternative Minimum Tax Definitions

Alternative minimum taxable income is figured using your taxable income with certain **adjustments** and increased by the amount of any ***tax preference items*** you have.

Adjustments. Certain adjustments (increases or decreases) must be made to your taxable income to arrive at your alternative minimum taxable income. For more information on adjustments, see Publication 909. The adjustments are shown in the table below.

Adjustments	**Description**
Standard deduction	No deduction is allowed
Itemized deductions	Itemized deductions for taxes, certain interest, and most miscellaneous deductions not allowed
Accelerated depreciation on new property	Depreciation used for alternative minimum tax is figured under the alternate method of the modified accelerated cost recovery system (MACRS) except that for personal property the 150% declining balance method is used
Circulation expenditures	Expenditures must be amortized ratably over 3 years
Research and experimental expenditures	Expenditures must be amortized ratably over 10 years
Mining exploration and development costs	Allowable costs must be amortized ratably over 10 years
Long-term contracts	For contracts entered into after February 28, 1986, figure income under the percentage of completion method
Pollution control facilities	Amortization figured under alternate MACRS
Certain installment sales by dealers	Installment method generally does not apply for alternative minimum tax
Passive activity losses	Net losses from passive activities, including tax shelter farm activities, not allowed
Alternative tax net operating loss	NOLs allowed with certain adjustments

Tax preference items. Tax preference items are other income items that receive special treatment under the tax laws. They must be added back to the taxable income shown on your return in figuring your alternative minimum taxable income. For individuals, tax preference items are listed below. For more information on tax preference items, see Publication 909.

Tax Preferences	**Description**
Depletion	Excess of depletion deduction over adjusted basis in property
Intangible drilling costs	Excess of deducted costs over the total of the amount allowable if costs were amortized ratably over 120 months plus 65% of net income from the properties
Incentive stock options	Excess of fair market value over option price at date of exercise
Accelerated depreciation on depreciable real property and depreciable leased personal property placed in service before 1987 (pre-MACRS property)	Excess of depreciation or amortization taken over straight-line deduction
Certain tax-exempt interest	Certain interest on specified private activity bonds
Appreciated property charitable deduction	Unrealized appreciation on donated long-term capital gain property

Exemption amount. You generally are allowed to exclude a certain amount of alternative minimum taxable income from your alternative minimum tax. You may have an alternative minimum tax liability if your

alternative minimum taxable income is more than the exemption amounts as follows:

- $40,000 and your filing status is married filing a joint return or qualifying widow(er),
- $30,000 and your filing status is single or head of household, or
- $20,000 and your filing status is married filing a separate return.

These exemption amounts start to phase out if your alternative minimum taxable income exceeds:

- $150,000 and your filing status is married filing a joint return or qualifying widow(er),
- $112,500 and your filing status is single or head of household, or
- $75,000 and your filing status is married filing a separate return.

See Publication 909 for a discussion of the exemption amount phaseout.

Computation of Tax

Your **alternative minimum tax** is computed as follows:

Begin with ***taxable income*** on return (line 37, Form 1040)
add or subtract
Adjustments to taxable income
add
Tax preferences
equals
Alternative minimum taxable income
subtract
Exemption amount
multiply by
21%
subtract
Foreign tax credit
equals
Tentative minimum tax
subtract
Regular Tax
equals
Alternative minimum tax

The result is entered on line 49 of Form 1040. See Publication 909 for information on the alternative minimum tax foreign tax credit.

Example. Sheila, a single taxpayer, had taxable income of $41,500 in 1988. She had adjustments and tax preference items of $42,200. She had no tax credits. She figures her alternative minimum tax as follows:

Taxable income		$ 41,500
Adjustments:		
Medical and dental expense	$ 500	
Miscellaneous itemized deductions from Schedule A	1,900	
Taxes from Schedule A	1,000	
Depreciation of property placed in service after 12/31/86	800	
Passive activity loss	10,000	
Total adjustments		14,200
Tax preference items:		
Incentive stock options	$ 2,500	
Intangible drilling costs	18,000	
Depletion	7,500	
Total tax preference items		28,000
Alternative minimum taxable income		$ 83,700
Less:		
Exemption amount for a single person		−30,000
Balance		$ 53,700
Tentative minimum tax:		
$53,700 x 21%	$ 11,277	
Less:		
Regular tax	−9,307	
Alternative minimum tax		$ 1,970

Use Form 6251, *Alternative Minimum Tax—Individuals,* to figure your alternative minimum tax. For more information and a complete explanation of this tax, see Publication 909.

Tax Figured by IRS

The Internal Revenue Service will figure your tax on Form 1040EZ, Form 1040A, or Form 1040.

Form 1040EZ. If you file your Form 1040EZ by April 17, 1989, you may choose to have the Internal Revenue Service figure your tax. Put your name and address label on your return. If you do not have a label, print (do not type) your name, address, and social security number in the spaces provided. If you want a dollar of your taxes to go to the Presidential Election Campaign Fund, check the *Yes* box. Read the instructions on the back of the form for lines 1 through 8 and fill in the lines that apply to you. Sign and date your return. Attach Copy B or the first copy of your Form W–2 to your return. Mail the return to the Internal Revenue Service Center for the area where you live.

Form 1040A. If you file Form 1040A by April 17, 1989, you may have the Internal Revenue Service figure your tax. Place your name and address label on your return or, if you do not have a label, fill in (print or type) your name, address, and social security number. On a joint return, show the names and social security numbers of both you and your spouse. If you are married, give the social security numbers of both spouses even if you file separately. Show the social security numbers in the same order that you show your first names. Check the appropriate box or boxes for the Presidential Election Campaign Fund.

What to complete. Read the Form 1040A instructions for lines 1 through 19 and fill in the lines that apply to you. Complete Parts II and III of Schedule 1 (Form 1040A) if they apply to you. If you complete any part of Schedule 1, attach it to your return when you file it.

If you are filing a joint return, show your taxable income and your spouse's taxable income separately in the margin to the left of line 19.

Read the instructions for line 21 and fill it in if it applies to you. If you claim the credit for child and dependent care expenses, you must also complete Part I of Schedule 1. If you received any advance earned income credit (EIC) payments, in the space to the left of the line 22 entry space, write "AEIC" and show the amount of the payment. Your Form(s) W–2 will show these payments. Complete line 23a. Attach Copy B or the first copy of your Forms W–2 to your return.

Earned income credit. If you qualify for the earned income credit, as discussed in Chapter 35, the Internal Revenue Service will figure the credit for you.

Filing the return. Sign and date your return. Also fill in your occupation. If you are filing a joint return, both you and your spouse must sign it. Show both your and your spouse's occupation on a joint return. Mail the return to the Internal Revenue Service Center for the area where you live.

Form 1040. You may choose to have the Internal Revenue Service figure your tax if:

- Your income consists only of wages, salaries, tips, interest, dividends, pensions, and annuities, and
- Your income on line 31, Form 1040, is not more than $50,000, and
- You do not itemize your deductions, and
- You are not required to file Form 8615, *Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000,* and,
- You do not use Form 2555, *Foreign Earned Income,* and
- You do not want any of your refund applied to your 1989 estimated tax, and
- You file your return by April 17, 1989.

Name, address, and social security number. Put your name and address label on your return. If you do not have a label, fill in (print or type) your name, address, and social security number. On a joint return, show the names and social security numbers of both you and your spouse. If you are married, give the social security numbers of both spouses even if you file separately. Show the social security numbers in the same order that you show your first names.

Check the appropriate *Yes* or *No* box or boxes for the Presidential Election Campaign Fund.

What to complete. Read the Form 1040 instructions for lines 1 through 37 and fill in the lines that apply to you.

If you are filing a joint return, use the space under the words *Adjustments to Income* on the front of your return to show your taxable income and your spouse's taxable income separately.

Read the Form 1040 instructions for lines 39 through 61. Fill in the lines that apply to you, but do not fill in the Total lines.

Fill in any forms or schedules asked for on the lines you completed and attach them to your return when you file it.

Credits. If you can take the credit for the elderly or the disabled, as discussed in Chapter 34, attach Schedule R. Write "CFE" on the dotted line to the left of line 42 of Form 1040. On Schedule R, enter your name and social security number, check the box for your filing status and age, and fill in lines 11 and 13 if applicable. Also complete Part II of Schedule R, if applicable.

If you qualify for the earned income credit, as discussed in Chapter 35, write "EIC" on line 56 of Form 1040.

Filing the return. Attach Copy B or the first copy of your Forms W–2 to your return.

Be sure to sign and date your return and show your occupation. If you are filing a joint return, both you and your spouse must sign it. Mail your return to the Internal Revenue Service Center for the area where you live.

If the Internal Revenue Service figures your tax and you paid too much, you will receive a refund. If you did not pay enough, you will receive a bill for the balance. You may avoid interest or the penalty for late payment if you pay the bill within 30 days of the date of the bill or by the due date for your return, whichever is later.

Note. If you did not pay enough tax, you may be charged a penalty for underpayment of estimated tax. See *Underpayment Penalty* in Chapter 5.

If you choose to have the Internal Revenue Service figure your tax, you may later change your mind by filing an amended return.

32. Tax on Investment Income of Certain Minor Children

A part of some children's income is taxed at their parents' tax rates. The rules explained here apply regardless of whether the children are dependents.

This chapter explains which children are required to use their parents' tax rates to figure the tax on their returns. It also explains how to figure the tax of children who are required to use their parents' tax rates.

This chapter is written for the parents of children who are under age 14 and have more than $1,000 of investment income.

Children to Whom This Method Applies

A part of your child's investment income may be subject to tax at your tax rates if:

- Your child has not reached age 14 at the close of the tax year, and
- Your child's investment income (defined later) is more than $1,000 for the year.

Note. This method of figuring tax does not apply to a child if neither of the child's parents is alive at the close of the tax year.

Child. For purposes of this chapter, the term ***child*** includes a legally adopted child and a stepchild.

Age 14. A child is considered to be 14 on the day before his or her 14th birthday.

Investment Income

Investment income generally includes all income other than salaries, wages, and other amounts received as pay for work actually done. It includes interest, dividends, capital gains, certain distributions from trusts, and the taxable part of social security payments and pension payments.

For these purposes, investment income includes only amounts that your child must include in gross (total) income. Any nontaxable investment income that your child receives, such as tax-exempt interest, is not included in figuring his or her investment income subject to the tax.

Your child's investment income subject to the tax includes all investment income your child must include in gross (total) income. It doesn't matter how or when your child obtained the property that produced the income. It includes income produced by property transferred to your child or purchased by your child, regardless of when the property was transferred or purchased and who transferred it. Investment income includes amounts produced by assets your child obtained with his or her earned income (such as interest on a savings account into which your child deposited wages).

Your child's investment income includes investment income produced by property given as gifts to your child under the Uniform Gift to Minors Act.

Example. Phil Black received the following income:

Dividends — $600
Wages — $2,100
Taxable interest — $1,200
Tax-exempt interest — $100
Net capital gains — $300.

Phil's investment income is $2,100. This is the total of the dividends ($600), taxable interest ($1,200), and net capital gains ($300). His wages are earned (not investment) income because they are pay received for work actually done. His tax-exempt interest is not included because it is nontaxable.

Trust income. Distributions of taxable interest, dividends, capital gains, and other investment income that your child receives as the beneficiary of a trust are also investment income to your child.

How to Figure Your Child's Tax

If your child received more than $1,000 of investment income during the year and was under age 14 at the end of the year, your child's tax is the **greater of:**

1) The income tax on your child's taxable income figured at your child's rates, or
2) The total of:
    a) Your child's share of a tentative tax (explained later) figured on your child's net investment income (defined later) at your rates, plus
    b) The income tax figured at your child's rates on the amount of your child's taxable income that remains after subtracting his or her net investment income.

Figure your child's tax on Form 8615, *Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000.* This is done in three steps:

1) Figure your child's net investment income.
2) Figure a tentative tax based on your tax rates.
3) Figure your child's tax.

These steps are explained later.

Caution: As this publication was being prepared for print, Congress was considering legislation that would affect the rules on how to figure the tax of a child under age 14 who has more than $1,000 of investment income.

The proposed legislation provides that the ***alternative minimum tax*** on the child's unearned minimum taxable income is the greater of:

1) The alternative minimum tax on the child's net unearned minimum taxable income figured without regard to this rule, or
2) The increase in the parent's alternative minimum tax (if any) that would be caused by including the child's net unearned minimum taxable income in the parent's alternative minimum taxable income.

The proposed legislation also provides that the following steps are to be followed when ***the parent's tax rates are being used to figure both the income tax of a trust and the child's income tax:***

1) Figure the tax of the trust without including any of the child's income in the income of the parent, then
2) Figure the child's tax after including the appropriate taxable income of the trust in the income of the parent.

For additional information on any late legislative changes, see Publication 553, *Highlights of 1988 Tax Changes.*

Information About Parent's Return

Before steps 1, 2, and 3 of your child's Form 8615 can be completed, you must determine which parent's name, social security number, filing status, and number of exemptions are to be entered on the form. Information from that parent's tax return will be used in completing Form 8615.

You determine which parent's name, social security number, filing status, and number of exemptions are entered on Form 8615 based on the marital status and filing status of you and your child's other parent.

Child's Parents Married

If you are married to your child's other parent, the information to be entered on Form 8615 depends on your filing statuses.

Joint return. If you and your child's other parent file a joint return, the name and social security number listed first on the joint return are entered in the appropriate spaces on your child's Form 8615. The box for married filing jointly is checked on the line for the parent's filing status and the number of exemptions claimed on the joint return is entered in the appropriate box.

Example. Jim's parents file a joint return. Jim's father's name is listed first on the joint return. Jim's parents claim three exemptions.

Jim's father's name and social security number are entered on Jim's Form 8615. The box for married filing jointly is checked on the line for the parent's filing status. "3" is entered in the box for the number of exemptions claimed.

Separate returns. If you and your child's other parent file separate returns, the name and social security number of the parent with the greater taxable income are entered in the appropriate spaces on your child's Form 8615. The box for married filing separately is checked on the line for the parent's filing status. The number of exemptions claimed on the return of the parent with the greater taxable income is entered in the appropriate box.

Example. Gwen's parents each file as married filing separately. Gwen's mother's taxable income is $42,000. Her father's taxable income is $37,000. Gwen's mother claims two exemptions. Her father claims one exemption.

Gwen's mother's name and social security number are entered on Gwen's Form 8615 because her mother's taxable income ($42,000) is greater than her father's ($37,000). The box for married filing separately is checked on the line for the parent's filing status. "2" is entered in the box for the number of exemptions claimed.

Parents not living together. If you and your child's other parent are married but are not living together, the parent with whom your child lives (the custodial parent) may be considered unmarried. If you or your child's other parent are considered unmarried, the name and social security number of the parent with whom your child lived for most of the year are entered in the appropriate spaces on your child's Form 8615. The box for that parent's filing status is checked on the Form 8615 and the number of exemptions claimed on that parent's return is entered in the appropriate box.

See *You are considered unmarried,* under *Head of Household,* in Chapter 2, for the tests you must meet to be considered unmarried.

Example. During 1988, Annie lived with her mother, Theresa, for 7 months. Theresa paid all of the costs of keeping up the house she lived in all year. Theresa's husband, who is Annie's father, did not live with Theresa at any time during the year. Theresa does not file a joint return with her husband. She claims one exemption for herself and one for Annie.

Theresa is considered unmarried. Theresa's name and social security number are entered on Annie's Form 8615. The box for head of household is checked on the line for the parent's filing status and "2" is entered in the box for the number of exemptions claimed.

Note. If the custodial parent is considered married, Form 8615 is filled out as explained under *Separate returns,* earlier.

Child's Parents Divorced

If you and your child's other parent are divorced, the information to be entered on your child's Form 8615 depends on which of you had custody of your child for most of the year and whether that parent remarried and is filing a joint return.

Generally, if you and your child's other parent are divorced, the name and social security number of the parent who had custody of the child for most of the year are entered in the appropriate spaces on your child's Form 8615. That parent's filing status is shown by checking the appropriate box on the form and the number of exemptions claimed on that parent's return is entered in the appropriate box.

Example. Amy's parents are divorced. Their divorce decree says that her mother and father have joint custody of Amy. Amy lived with her father for 7 months during the year. Amy's father claimed four exemptions on his return.

Amy's father's name and social security number are entered on Amy's Form 8615. The box for Amy's father's filing status is checked on the form and "4" is entered in the box for the number of exemptions claimed.

Custodial parent remarried and filing joint return. If the parent who had custody of your child for most of the year files a joint return with a spouse who is not a parent of your child, the name and social security number of the person listed first on that joint return are entered in the appropriate spaces on your child's Form 8615. The box for married filing jointly is checked on the line for the parent's filing status. The number of exemptions claimed on the joint return of the custodial parent is entered in the appropriate box on Form 8615.

Example. Mark's parents are divorced and his mother has remarried. The divorce decree grants custody of Mark to his mother. Mark lived with his mother all year. His mother files a joint return with her current spouse, Mark's stepfather. Mark's stepfather's name is listed first on the joint return. Mark's mother and stepfather claim five exemptions on their joint return.

Mark's stepfather's name and social security number are entered on Mark's Form 8615. The box for married filing jointly is checked on the line for the parent's filing status and "5" is entered in the box for the number of exemptions claimed.

Child's Parents Not Married

If you and your child's other parent did not marry each other, the rules for which parent's information to enter on your child's Form 8615 are the same as the rules for parents who are divorced.

Example. John is 9 and has investment income subject to tax at his parent's tax rates. His parents have never married. He lives with his mother, who claims two exemptions on her return.

John's mother's name and social security number are entered on John's form 8615. Her filing status is shown on the line for the parent's filing status and "2" is entered in the box for the number of exemptions claimed.

Figuring Net Investment Income

Your child's net investment income is generally his or her gross (total) investment income reduced by the sum of the following three items:

1) Adjustments to income attributable to his or her investment income (such as the penalty on early withdrawal of savings), plus
2) $500, plus
3) The greater of $500, or your child's itemized deductions that are ***directly connected*** (defined later) with the production of his or her investment income.

Example 1. Elenora, 8, is claimed as a dependent on her grandfather's return. She has investment income of $16,000 and an early withdrawal penalty of $100. She has itemized deductions of $1,100 that are directly connected with the production of her investment income. Elenora's net investment income is $14,300. This is her total investment income of $16,000 reduced by $1,700. The $1,700 is the sum of the $100 early withdrawal penalty, plus $500, plus the $1,100 of directly-connected itemized deductions.

Example 2. Roger, 12, is claimed as a dependent on his parents' return. He has investment income of $8,000, no adjustments to income, and $300 of itemized deductions that are directly connected with his investment income. His net investment income is $7,000. This is his total investment income of $8,000 reduced by $1,000 ($500 + $500).

His investment income is reduced by $1,000 because he has no adjustments to income and his directly-connected itemized deductions are not more than $500.

Directly-connected itemized deductions are those for expenses paid to produce or collect income or to manage, conserve, or maintain property held for producing income. Only the part of the total expenses that is more than the 2% of adjusted gross income limit on miscellaneous itemized deductions can be deducted. These expenses include custodian fees and service charges, service fees to collect interest and dividends, and investment counsel fees. See Chapter 30 for more information about the 2% of adjusted gross income limit on miscellaneous itemized deductions.

Net investment income more than taxable income. If your child's net investment income is more than his or her taxable income, use the taxable income to figure the tax.

Figuring Tentative Tax At Your Tax Rates

The tentative tax is the difference in tax, based on your tax rates, on your income figured with and without your child's net investment income. Figure it as follows:

1) Figure the tax on the total of your taxable income plus your child's net investment income, at your tax rates.
2) Figure the tax on your taxable income without including your child's net investment income.
3) Subtract the tax in (2) from the tax in (1). This is the tentative tax.

Do not take into account your child's net investment income in figuring any exclusion, deduction, or credit on your return.

If your child cannot get the required information about his or her parents' taxable income or which parent is claiming his or her exemption, your child (or your child's legal representative) may request, in writing, the necessary information from the Internal Revenue Service.

More Than One Child

If you have more than one child subject to these rules (including adopted children and stepchildren), include the net investment income of all these children when figuring the tentative tax. You then allocate the tentative tax to each of the children according to each child's share of net investment income.

If the information from the other children is not available when the return is due, either file the return using estimates or request an extension of time to file. Extensions are discussed in Chapter 1.

Allocation of tentative tax. Allocate the tentative tax to each of your children by multiplying the total tentative tax by fractions. The numerator (top number) of each fraction is each child's net investment income. The denominator (bottom number) of all the fractions is the net investment income of all your children. The result of each multiplication is each child's share of the tentative tax.

Example. The Oaks' two children, Bill and Patty, ages 11 and 12, have $2,000 and $3,000 of net investment income. Tax on their income must be figured at their parents' rates.

Bill's and Patty's net investment income is combined and the total ($5,000) is added to their parents' taxable income. The difference between the tax on their parents' taxable income and the tax on their parents' taxable income plus the children's net investment income is $1,750. This difference (the tentative tax) must be allocated between Bill and Patty.

The amount allocated to Bill is $700 [($2,000/$5,000) × $1,750].

The amount allocated to Patty is $1,050 [($3,000/$5,000) × $1,750].

Figuring Your Child's Tax

The final step in figuring your child's tax using Form 8615 is to determine the larger of:

1) The total of:
   a) Your child's share of the tentative tax based on the parent's tax rates, plus
   b) The income tax, figured at your child's rates, on the amount of your child's taxable income that remains after subtracting his or her net investment income, or
2) The income tax on your child's taxable income figured at your child's rates.

Form 8615

If your child had not reached age 14 by December 31, 1988, and he or she received more than $1,000 of investment income during 1988, use Form 8615, *Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000*, to figure your child's tax.

Completing Form 8615

In reading the discussions which follow, it may be helpful to refer to the filled-in example later in this chapter.

Parent's information. Enter on Form 8615 the name, filing status, and social security number of the parent whose taxable income is being used to figure the tentative tax based on the parent's tax rates. Also enter the number of exemptions claimed on that parent's tax return.

If the total taxable income on a joint return is being used to figure the tentative tax, enter the name and social security number of the person who is listed first on the joint return.

Example. In Glenn's case, the tentative tax must be figured using the total taxable income on the joint return of his mother and his stepfather. His stepfather's name and social security number are listed first on the joint return.

The Form 8615 attached to Glenn's tax return will show his stepfather's name, a check in the box for married filing jointly, and his stepfather's social security number.

Investment income (line 1). If your child has investment income ***only***, enter the adjusted gross income shown on the child's return. Adjusted gross income is shown on line 31 of Form 1040 or line 13 of Form 1040A. Form 8615 cannot be used with Form 1040EZ.

If your child had earned income, the amount to enter on line 1 of Form 8615 generally can be figured by using the worksheet in the instructions for the form.

However, if your child has excluded any foreign earned income or deducted either a loss from self-employment or a net operating loss from another year, add these amounts to the result on line 3 of the worksheet.

Tax on parent's taxable income plus children's net investment income (line 9). Use the Tax Table or Tax Rate Schedules to figure the amount to enter on line 9.

If the amount on line 8 is ***less than $50,000***, you must use the Tax Table to figure the amount to enter on line 9. If the amount on line 8 is ***$50,000 or more***, you must use the Tax Rate Schedules.

Tax on excess of child's income over child's net investment income (line 15). You must use the Tax Table or Tax Rate Schedule X to figure the amount to enter on line 15.

Illustrated Example

The following example includes a completed Form 8615.

Example. John and Laura Brown have one child, Sara. She is 13 and has $2,300 of interest and dividend income and $1,500 of earned income. She does not itemize deductions. John and Laura file a joint return with John's name and social security number listed first. They claim three exemptions, including an exemption for Sara, on their return.

Because Sara has unearned income and gross income of more than $500, she must file a tax return. Because she is under age 14 with more than $1,000 of investment income, part of her income may be subject to tax at her parents' rates. She must attach a completed Form 8615 to her return. Sara's Form 8615 is shown here.

Sara's father, John, fills out Sara's return for her.

John enters his name and social security number on Sara's Form 8615 because his name and number are listed first on the joint return he is filing. He checks the box for married filing jointly and enters "3" in the box for the number of exemptions claimed.

He enters Sara's investment income, **$2,300, on line 1**. Sara does not itemize deductions, so John enters **$1,000 on line 2**. He enters **$1,300 on line 3** ($2,300 − $1,000).

Sara's taxable income is $2,300. This is her total income ($3,800) minus her standard deduction ($1,500). Her standard deduction is limited to the amount of her earned income.

John enters **$2,300 on line 4.** This is Sara's taxable income on line 19 of her Form 1040A. John compares the amounts on lines 3 and 4 and enters the smaller amount, **$1,300, on line 5**.

John enters **$48,000 on line 6**. This is the taxable income from line 37 of John and Laura's joint return. Sara is an only child, so John enters **0 on line 7.** He adds the amounts on line 5 ($1,300), line 6 ($48,000), and line 7 (0), and enters the total, **$49,300, on line 8.**

Using the column for married filing jointly in the Tax Table, John finds the tax on $49,300. He enters the tax, **$9,944, on line 9** and checks the box for Tax Table on that line. He enters **$9,580 on line 10.** This is the tax from line 38 of John and Laura's Form 1040. John also checks the box for Tax Table on line 10. He enters **$364 on line 11** ($9,944 − $9,580).

John skips lines 12a and 12b and enters **$364 on line 13**.

John subtracts the amount on line 5 ($1,300) from the amount on line 4 ($2,300) and enters the result, **$1,000, on line 14.** Using the column for single filing status in the Tax Table, John finds the tax on $1,000. He enters the tax, **$152, on line 15** and checks the box for Tax Table on that line. He adds the amounts on lines 13 ($364) and 15 ($152) and enters the total, **$516, on line 16.**

Using the column for single filing status in the Tax Table, John finds the tax on $2,300 (the amount on line 4). He enters the tax, **$347, on line 17** and checks the box for Tax Table on that line.

John compares the amounts on lines 16 and 17 and enters the larger amount, **$516, on line 18** of Sara's Form 8615. He also enters that amount on line 20 of Sara's Form 1040A.

John also completes Schedule 1 (Form 1040A) for Sara. Her filled-in Schedule 1 is not shown here.

Form **8615**

Department of the Treasury
Internal Revenue Service

Computation of Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000

▶ **See instructions below and on back.**

▶ **Attach ONLY to the Child's Form 1040, Form 1040A, or Form 1040NR.**

OMB No. 1545-0998

1988

Attachment Sequence No. 33

General Instructions

Purpose of Form. For children under age 14, investment income (such as taxable interest and dividends) over $1,000 is taxed at the parent's rate if the parent's rate is higher than the child's rate.

Do not use this form if the child's investment income is $1,000 or less. Instead, figure the tax in the normal manner on the child's income tax return. For example, if the child had $900 of taxable interest income and $200 of income from wages, Form 8615 is not required to be completed and the child's tax should be figured on Form 1040A using the Tax Table.

If the child's investment income is more than $1,000, use this form to see if any of the child's investment income is taxed at the parent's rate and, if so, to figure the child's tax. For example, if the child had $1,100 of taxable interest income and $200 of income from wages, Form 8615 should be completed and attached to the child's Form 1040A.

Investment Income. As used on this form, "investment income" includes all taxable income other than earned income as defined on page 2. It includes income such as taxable interest, dividends, capital gains, rents, royalties, etc. It also includes pension and annuity income and income (other than earned income) received as the beneficiary of a trust.

Who Must File. Generally, Form 8615 must be filed for any child who was under age 14 on January 1, 1989, and who had more than $1,000 of investment income. If neither parent was alive on December 31, 1988 do not use Form 8615. Instead, figure the child's tax based on his or her own rate.

Additional Information. For more information about the tax on investment income of children, please get **Pub. 929**, Tax Rules for Children and Dependents.

(Instructions continue on back.)

Child's name as shown on return: Sara N. Brown

Child's social security number: 111 : 00 : 9999

Parent's name (first, initial, and last). (**Caution:** See instructions on back before completing.): John Q. Brown

Parent's social security number: 999 : 00 : 1111

Parent's filing status (check one): ☐ Single, ☒ Married filing jointly, ☐ Married filing separately, ☐ Head of household, or ☐ Qualifying widow(er)

Enter number of exemptions claimed on parent's return ▶ 3

Step 1 Figure child's net investment income

1	Enter the child's investment income, such as taxable interest and dividend income (see Instructions). (If this amount is $1,000 or less, stop here; do not file this form.)	1	2,300
2	If the child DID NOT itemize deductions on Schedule A (Form 1040 or Form 1040NR), enter $1,000. If the child ITEMIZED deductions, see the Instructions.	2	1,000
3	Subtract the amount on line 2 from the amount on line 1. Enter the result. (If zero or less, stop here; do not complete the rest of this form but ATTACH it to the child's return.)	3	1,300
4	Enter the child's **taxable** income (from Form 1040, line 37; Form 1040A, line 19; or Form 1040NR, line 36)	4	2,300
5	Compare the amounts on lines 3 and 4. Enter the **smaller** of the two amounts ▶	5	1,300

Step 2 Figure tentative tax based on the tax rate of the parent listed above

6	Enter the parent's **taxable** income (from Form 1040, line 37; Form 1040A, line 19; Form 1040EZ, line 7; or Form 1040NR, line 36)	6	48,000
7	Enter the total, if any, of the net investment income from Forms 8615, line 5, of ALL OTHER children of the parent. (Do not include the amount on line 5 above.)	7	-0-
8	Add the amounts on lines 5, 6, and 7. Enter the total	8	49,300
9	Tax on the amount on line 8 based on the **parent's** filing status (see Instructions). Check if from ☒ Tax Table or ☐ Tax Rate Schedules	9	9,944
10	Enter the parent's tax (from Form 1040, line 38; Form 1040A, line 20; Form 1040EZ, line 9; or Form 1040NR, line 37). Check if from ☒ Tax Table or ☐ Tax Rate Schedules	10	9,580
11	Subtract the amount on line 10 from the amount on line 9. Enter the result. (If no amount is entered on line 7, enter the amount from line 11 on line 13; skip lines 12a and 12b.)	11	364
12a	Add the amounts on lines 5 and 7. Enter the total — 12a		
b	Divide the amount on line 5 by the amount on line 12a. Enter the result as a decimal (rounded to two places)	12b	× .
13	Multiply the amount on line 11 by the decimal amount on line 12b. Enter the result ▶	13	364

Step 3 Figure child's tax

	Note: *If the amounts on lines 4 and 5 are the same, skip to line 16.*		
14	Subtract the amount on line 5 from the amount on line 4. Enter the result — 14: 1,000		
15	Tax on the amount on line 14 based on the **child's** filing status (see Instructions). Check if from ☒ Tax Table or ☐ Tax Rate Schedule X	15	152
16	Add the amounts on lines 13 and 15. Enter the total	16	516
17	Tax on the amount on line 4 based on the **child's** filing status. Check if from ☒ Tax Table or ☐ Tax Rate Schedule X	17	347
18	Compare the amounts on lines 16 and 17. Enter the **larger** of the two amounts here and on Form 1040, line 38; Form 1040A, line 20; or Form 1040NR, line 37. Be sure to check the box for "Form 8615" ▶	18	516

For Paperwork Reduction Act Notice, see back of form.

Form **8615** (1988)

33. Child and Dependent Care Credit

Important Change for 1988

Overnight camp expenses no longer qualify for the child and dependent care credit. See *Work-Related Expenses,* later.

If you pay someone to care for your dependent who is under 15, your disabled dependent, or your disabled spouse so that you can work or look for work, you may be able to take a tax credit of up to 30% of the amount you pay. You may use up to $2,400 of these expenses to figure your credit if you have one qualifying person and up to $4,800 if you have two or more qualifying persons. Your credit can be as much as $720 if you have one qualifying person or as much as $1,440 if you have two or more qualifying persons. See *Limits on Work-Related Expenses* later, for the rules for figuring your credit.

If you can take the child and dependent care credit, you may want to claim more withholding allowances to have less income tax withheld from your pay. See Chapter 5 for additional information.

If you pay someone to look after your dependent or spouse in your home, you may be a household employer. See *Employment Taxes for Household Employers,* later, for a discussion of how to figure employment taxes and what forms you must file if you are a household employer. For more information, see Publication 926, *Employment Taxes for Household Employers.*

General Requirements

To be able to claim the credit:

1) You must file Form 1040 or Form 1040A, not Form 1040EZ,
2) Your child and dependent care expenses must be incurred to allow you (and your spouse if you were married) to work or look for work (but see *Student-spouse or spouse not able to care for himself or herself* later),
3) You must have income from work during the year,
4) You (and your spouse if you were married) must keep up a home that you live in with one or more qualifying persons,
5) You must file a joint return if you are married, unless the exceptions discussed later under *Marital Status* apply to you, and
6) You must have made payments for child and dependent care to someone you or your spouse could not claim as a dependent and, if the person you made payments to was your child, he or she must have been 19 or older by the end of the year.

Caution: Beginning in 1989 you will be required to get the name, address, and taxpayer identification number (usually the social security number) of the child or dependent care provider and report this information when you file your 1989 tax return (by April 16, 1990). You can use Form W-10, *Dependent Care Provider's Identification and Certification,* to get this information from the provider.

Work Requirement

Your work can be for others, full time or part time, or in your own business or partnership. Work may include actively looking for work. However, if you do not find a job and have no earned income for the year, you cannot take the credit. See *Earned Income Limit,* later. Unpaid volunteer work or volunteer work for a nominal salary does not qualify.

If you are married, you must file a joint return, unless you meet the requirements under *Marital Status,* discussed later. Both you and your spouse must work. If you work and your spouse does not, your spouse is treated as working and earning income during any month the rules in the next paragraph are met. Figure the earned income of the nonworking spouse as shown under *Earned Income Limit,* later.

Student-spouse or spouse not able to care for himself or herself. Your spouse is considered to have worked if for any month he or she was:

1) A full-time student during at least some part of each of 5 months during the tax year, or
2) Physically or mentally not able to care for himself or herself.

This rule applies to only one spouse for any one month. If, in the same month, both you and your spouse did not work and were either full-time students or physically or mentally not able to care for yourselves, neither of you will be treated as working and earning income in that month.

Surviving spouse. If your spouse died during 1988 and you file a joint return as a surviving spouse, you are not considered married for purposes of the credit. Therefore, it does not matter whether your spouse worked, was a full-time student, or was able to care for himself or herself during the year.

Keeping Up a Home

You are keeping up a home for a tax year if you (and your spouse, if you are married) pay more than half the cost of running it for that year. Your home means your main home. It must be your home as well as the home of a qualifying person, discussed later. A qualifying person's:

1) Birth,
2) Death, or
3) Temporary absence due to:
    a) Sickness,
    b) School,
    c) Business,
    d) Vacation,
    e) Military service, or
    f) Custody agreement

will not stop your home from being the person's main home.

Upkeep expenses normally include property taxes, mortgage interest, rent, utility charges, home repairs, insurance on the home, and food eaten at home.

Do not include in upkeep payments for clothing, education, medical treatment, vacations, life insurance, transportation, mortgage principal, or the purchase, permanent improvement, or replacement of property. For example, the cost of replacing a water heater is not considered upkeep, but the cost of repairing a water heater can be included.

Qualifying Persons

Your work-related expenses must be for the care of one or more members of your home who are qualifying persons. A qualifying person is:

1) Your dependent under 15 for whom you can claim an exemption deduction (but see *Child of divorced or separated parents,* later), or
2) Your dependent, or a person you could claim as a dependent except that the person has gross income of $1,950 or more, who is physically or mentally not able to care for himself or herself, or
3) Your spouse who is physically or mentally not able to care for himself or herself.

Physical or mental incapacity must be disabling. Persons who are not able to dress, clean, or feed themselves because of physical or mental problems are not able to care for themselves. Persons with mental defects who require constant attention to prevent them from injuring themselves or others are considered not able to care for themselves.

Qualification is determined on a daily basis when the qualifying status of a person lasts for less than a calendar month. For example, if the person for whom you paid work-related expenses no longer qualifies on September 16, you may include your work-related expenses through September 15 in your computation. See *Dollar Limit,* later.

Child of divorced or separated parents. If you are divorced or separated, as defined later, and you are the custodial parent (had custody for the greater part of the year), your child is a qualifying person if he or she:

1) Was under 15 or not able to care for himself or herself,
2) Was in the custody of one or both parents for more than half of the year, and
3) Received more than half of his or her support from one or both parents.

Special rule. Generally, a qualifying person must be a dependent. However, if the noncustodial parent can claim a child as a dependent, the child will still be a qualifying person for the custodial parent if:

1) The noncustodial parent claims the child's dependency exemption because you signed Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents,* or a similar statement, or
2) The noncustodial parent provided at least $600 for the child's support and can claim the dependency exemption under a qualified pre-1985 instrument. A qualified pre-1985 instrument is a decree of divorce or separate maintenance or a written agreement, that took effect before 1985, provides the dependency exemption to the noncustodial parent, and has not since been modified to specify that this provision will not apply.

Example. You are divorced and have custody of your 8-year-old child. You sign Form 8332 to allow your ex-spouse to take the dependency exemption. You pay child care expenses so you can work. Your child is a qualifying person and you can claim the credit for your work-related expenses, even though your ex-spouse claims the child as a dependent.

Divorced or separated defined. The above rules apply if you:

- Are divorced or separated under a decree of divorce or separate maintenance,
- Are separated under a written separation agreement, or
- Lived apart from your spouse at all times during the last 6 months of the year.

Work-Related Expenses

Only work-related expenses qualify for the credit. Your expenses must have been for the well-being and protection of a qualifying person. They are considered work related only if they allow you (and your spouse, if you are married) to work. Expenses are not considered work related merely because you had them while you were working. Whether you had the expenses to allow you to work depends on the facts.

You must have paid the expenses to care for one or more qualifying persons, or for household services if part of the services was for the care of qualifying persons. You do not have to choose the least expensive manner of providing the care.

If you are married, both you and your spouse must work. In certain cases, however, your spouse does not have to work. See *Student-spouse or spouse not able to care for himself or herself*, earlier.

Note: Previously, expenses eligible for the child and dependent care credit included amounts paid for overnight camps. Beginning in 1988, do not count any expense for an overnight camp when figuring your child and dependent care credit. This expense is no longer considered as paid to allow you to work.

Work-related expenses include:

1) Expenses for household services, and
2) Expenses for the care of a qualifying person.

Expenses for household services. Expenses you paid for ordinary services done in and around your home that were necessary to run your home are included even if they were only ***partly*** for the well-being and protection of a qualifying person. The services of a housekeeper, maid, or cook are usually considered necessary to run your home if performed at least partly for the benefit of the qualifying person. However, do not include payment for services of a chauffeur or gardener.

Household services do not include expenses for a qualifying person's:

1) Food,
2) Clothing,
3) Education, or
4) Entertainment.

If part of an expense is work related and part is for other purposes, you have to allocate the expense. Count only the part that is work related (for household services or for the care of a qualifying person). However, you do not have to allocate the expense if the part for the other purposes is small.

All of your expenses for housework are work related even if only part of them are for a qualifying person.

Example. You pay a housekeeper to care for your 9-year-old and 15-year-old children so that you can work. The housekeeper spends most of the time doing the regular household work, cleaning and cooking, and spends 30 minutes a day driving you to and from work. The entire expense of the housekeeper is a work-related expense. You do not have to deduct any amount for being driven to and from work because the time involved is minimal. You do not have to deduct any amount for the care of the 15-year-old child (not a qualifying person) because the household expense is partly for the care of the 9-year-old child, who is a qualifying person.

Expenses for the care of a qualifying person. The main reason to have expenses for the care of a qualifying person must be for the person's well-being and protection. These expenses do not include amounts you paid for clothing, entertainment, food, or schooling. However, if these amounts are incident to and cannot be separated from the cost of caring for a qualified person, you can count the total cost. For example, if a nursery school or day-care center provides lunch and educational services as a part of its preschool child care service, you can count the entire cost.

You cannot count the cost of schooling in the first grade or higher. You must divide the total cost between the cost of caring for the child and the cost of schooling.

Example. You place your 10-year-old child in a boarding school so you can work full time. Only the part of the boarding school expense that is for the care of your child is included in your work-related expenses. You cannot use any part of the amount you pay the school for your child's education as a work-related expense.

You can include the cost of care provided outside your home if the care was for your dependent under age 15 or for any other qualifying person who regularly spends at least 8 hours each day in your household. Care that is provided outside your home by a dependent care center may be included, provided the center complies with all applicable state and local regulations.

The cost of getting the qualifying person to and from your home and the care location is ***not*** considered a work-related expense. This includes the costs of bus, subway, taxi, or private car.

A dependent care center is a place that provides care for more than six persons (other than persons who live there) and receives a fee, payment, or grant for providing services for any of those persons, regardless of whether or not the center is run for profit.

Meals and lodging provided for housekeeper. If your housekeeper ate in your home, add to your work-related expenses the part of your total food cost that was for the housekeeper. If you had extra expenses for your housekeeper's lodging, add these expenses to your work-related expenses. For example, if you moved to an apartment with an extra bedroom for the housekeeper, add the extra rent and utility expenses for this bedroom to your work-related expenses.

Do not include the value of meals provided for your own convenience as wages on the Form W–2, *Wage and Tax Statement*, you give your housekeeper. Do not include the value of lodging if you provide it for your convenience and require the housekeeper to live in your home.

Taxes paid on wages. If you pay wages for household help, you may have to pay the employer's portion and withhold the employee's portion of the social security tax (FICA). You also may have to pay federal unemployment tax (FUTA) and similar state taxes. See *Employment Taxes for Household Employers*, later. To figure your credit, include in your work-related expenses the taxes that you pay on wages for qualifying child and dependent care services.

Payments to a housekeeper while you are out sick. Do not include as work-related expenses amounts you pay to a housekeeper for household and care expenses while you are off from work because of illness. This rule applies even if you get sick pay and continue to be considered an employee.

Work-related expenses are determined on a daily basis if you worked, or actively looked for work, only part of the period covered by the expenses. For example, if you paid care expenses of $120 a month ($1,440 for the year), all the expenses would be work-related if you worked all year. However, if you only worked or looked for work 2 months and 10 days during the year, your work-related expenses would be limited to $280 (2⅓ months × $120).

Payments to relatives. Count work-related payments you made to relatives who are not your dependents, even if they lived in your home. However, do not count any payments you made to:

1) A dependent for whom you (or your spouse if you are married) can claim an exemption, or
2) Your child who was under the age of 19 at the end of the year.

Limits on Work-Related Expenses

There are limits on the amount of work-related expenses you can use to figure the credit: an ***earned income limit*** and a ***dollar limit.***

Earned Income Limit

The amount of your work-related expenses during any tax year that you use to figure your credit cannot be more than:

1) Your earned income for the year, if you are single at the end of the year, or
2) The smaller of your earned income or your spouse's earned income for the year, if you are married at the end of the year.

If you remarried during the year, use only the earned income of the spouse you are married to at the end of the year.

Earned income includes wages, salaries, tips, other employee compensation, and net earnings from self-employment. Earned income also includes strike benefit payments and disability pensions reported as wages (see Chapter 11). You should disregard community property laws when you figure your earned income for this credit.

If you have your own business, you must include your net earnings in earned income, even if they are less than $400. You may figure your net earnings from your business either by the regular method or the optional method. If you are eligible to choose the optional method of figuring self-employment tax, you may use up to $1,600 as the amount of earned income. See Publication 533, *Self-Employment Tax*, for more information. Your losses from your business reduce earned income.

Income exempt from self-employment tax as a result of the filing and approval of Form 4361 (generally relating to the clergy) is earned income if it is wages, salaries, tips, or other employee compensation. This includes your housing allowance or the rental value of the parsonage that you get as part of your pay for services as an employee.

Income exempt from self-employment tax as a result of the filing and approval of Form 4029 (relating to members of certain religious faiths) is not earned income.

Earned income does not include pensions or annuities (other than disability pensions). social security payments, workers' compensation, or unemployment compensation.

Student-spouse or disabled spouse. If you are married and, for any month, your spouse is either a full-time student or not able to care for himself or herself, your spouse will be considered to have earned income of $200 for that month if there is one qualifying person in your home, or $400 if there are two or more qualifying persons in your home. If you are a full-time student for only part of a month, the full $200, or $400, amount still applies. A spouse who cannot care for herself or himself is counted as a qualifying person. Only one spouse can be considered to have this earned income of $200, or $400, for any one month. Full-time student is defined in Chapter 3.

If, in the same month, both you and your spouse were full-time students and did not work, you cannot use any amount paid that month to figure the credit, even if you were looking for work. The same applies to a couple who did not work because neither was capable of self-care.

Surviving spouse. If your spouse died during 1988 and you file a joint return with your deceased spouse, you are not considered married for purposes of the credit. Consider only your income in figuring the earned income limit.

Dollar Limit

You may be able to take a tax credit of up to 30% of the work-related expenses you paid during your tax year. However, your work-related expenses are limited to $2,400 for one qualifying person, or $4,800 for two or more qualifying persons.

The $2,400, or $4,800, is a yearly limit. Use the $2,400 limit if you had one qualifying person at any time during the year. Use $4,800 if you had more than one at any time during the year. Although the limit is not based on the length of time during the year that the person qualified, the work-related expenses are.

In figuring the credit, use only the work-related expenses you had for a qualifying person during the time the person qualified. For example, if your child turned 15 in August, use only the expenses, but not more than $2,400, you had before your child's fifteenth birthday. If you had expenses of less than $2,400 during the time your child qualified, use only the smaller amount.

The most you can reduce your tax in any year is $720 if your expenses are for one qualifying person, or $1,440 if the expenses are for two or more.

The credit is 30% of work-related expenses if your adjusted gross income is $10,000 or less. The 30% is reduced by one percent for each $2,000 of adjusted gross income, or part of $2,000, above $10,000 until the percentage is reduced to 20% for income above $28,000. The following table shows the applicable percentages for the adjusted gross incomes.

Adjusted Gross Income			Applicable Percentage
Over		But not over	
$ 0	—	$10,000	30%
10,000	—	12,000	29%
12,000	—	14,000	28%
14,000	—	16,000	27%
16,000	—	18,000	26%
18,000	—	20,000	25%
20,000	—	22,000	24%
22,000	—	24,000	23%
24,000	—	26,000	22%
26,000	—	28,000	21%
28,000	—	No Limit	20%

Marital Status

The following discussion explains when married couples must file a joint return to take the credit and when they can file separate returns and still take the credit.

Married couple. If you are married at the end of your tax year, you must file a joint return with your spouse to take the credit.

If you are legally separated from your spouse under a decree of divorce or separate maintenance, you are not considered married. You can take the credit on a separate return.

Married and living apart. You will not be considered married if:

1) You file a separate return,
2) Your home was the home of a qualifying person for more than half the year,
3) You paid more than half the cost of keeping up your home for the year, and
4) You spouse did not live in your home for the last 6 months of the year.

Examples

The following examples show the computation of the credit in various circumstances. Example 4 is illustrated by the filled-in Form 2441 at the end of this chapter.

Example 1: Child Care—Two Children

You are a widow and you keep up a home for yourself and your two preschool children who are your dependents. You file a Form 1040A and have adjusted gross income of $20,000. The entire amount is earned income.

During the year you pay work-related expenses of $3,000 for a neighbor to care for your children in her home and $2,200 for child care at a nursery school.

Figure your credit as follows:

Child care by neighbor	$3,000
Add: Child care by nursery school	2,200
Total work-related expenses	$5,200
Maximum allowable expenses for two qualifying children	$4,800
Amount of credit (25% of $4,800)	$1,200

Because you have earned income of at least $4,800, the earned income limit, discussed earlier, does not apply.

Example 2: Dependent Care—One Person

You are single. You work and keep up a home for yourself and your dependent father. Your adjusted gross income of $25,000 is entirely earned income.

Your father is disabled and incapable of self-care for 6 months. To keep working, you pay a housekeeper $500 a month to care for your father, prepare lunch and dinner, and do housework. Employment taxes for household employers, discussed later, are not considered in this example.

Figure your credit as follows:

Total work-related expenses (6 × $500)	$3,000
Maximum allowable expenses	$2,400
Amount of credit (22% of $2,400)	$ 528

Because you have earned income of at least $2,400, the earned income limit, discussed earlier, does not apply.

Note. As stated earlier under *Qualifying Persons*, if the dependent for whom you have the work-related expenses is disabled for only part of a month, the total work-related expenses are limited to that part of the month.

Example 3: Disabled Spouse

You are married. You work and keep up a home for yourself and your spouse. You file a joint return and have adjusted gross income of $29,000. The entire amount is earned income. Because of an accident, your spouse is incapable of self-care for the entire tax year.

To keep working, you pay a neighbor $2,000 to take care of your spouse.

Figure your credit on the smallest of the following amounts:

1) Total work-related expenses	$ 2,000
2) Your earned income	$29,000
3) Income considered earned by your disabled spouse (12 × $200)	$ 2,400
Allowable credit (20% of $2,000)	$ 400

Example 4: Student-Spouse

John Harris works and keeps up a home for himself, his wife Peggy, and their two children (both under 15). John has adjusted gross income of $35,000. The entire amount is earned income.

Peggy is a full-time student at State University from January 4 through June 10. She does not return to school after June 10.

They paid a neighbor $500 a month from January 4 to June 10 (total $3,000) to care for their two children, in her home, while they are not in school.

They figure the credit on the smallest of the following amounts:

1) Total work-related expenses	$ 3,000
2) John's earned income	$35,000
3) Income considered earned by Peggy (6 × $400)	$ 2,400
Allowable credit (20% of $2,400)	$ 480

This example is shown on the filled-in Form 2441 in this chapter.

How to Claim the Credit

To claim the credit, you may file your return on Form 1040 or Form 1040A. You cannot claim the credit on Form 1040EZ. You must file a joint return if you are married, unless the exceptions discussed earlier under *Marital Status* apply to you.

Form 1040. Complete Form 2441, *Credit for Child and Dependent Care Expenses,* and attach it to your Form 1040.

Form 1040A. Complete Schedule 1 (Form 1040A), Part I, *Credit for child and dependent care expenses,* and attach it to Form 1040A. See Chapter 37 for an example and a filled-in Part I of Schedule 1.

Tax credit not refundable. The child and dependent care credit is limited to your tax liability. It is ***not*** refundable.

Alternative Minimum Tax limit. In some cases the amount of credit may be additionally limited because of the alternative minimum tax. If you filed Schedules C, D, E, or F (Form 1040), you should complete Form 6251, *Alternative Minimum Tax—Individuals,* to figure if your credit will be limited. If you did not file Schedules C, D, E, or F, you should complete the worksheet that comes with the instructions for line 8, Form 2441, to determine if you still need to complete Form 6251.

Expenses not paid until the following year. You may include only the expenses that you pay during the year for which you are taking the credit. For example, if you are a calendar year taxpayer and had expenses in December 1987, but did not pay them until January 1988, you could not claim the expenses on your 1987 Form 2441. You may be able to claim all or part of this amount on line 7 of your 1988 Form 2441. You must attach a sheet showing how you figured the amount you claim on line 7. You cannot claim this amount if you file Form 1040A. See Publication 503 for an example.

Expenses prepaid in earlier year. If you pay for services before they are provided, you may claim the prepaid expenses only in the year the services are performed. Fill out your Form 2441 or Schedule 1 (Form 1040A), Part I, for the later year as if you paid the prepaid expense in the later year.

Medical expenses. Some disabled dependent care expenses may qualify as work related and also as medical expenses. You can use them either way as long as you do not use the same expenses to claim both a credit and a medical expense deduction. If you use these expenses first to figure the credit and they are more than the earned income limit or the dollar limit, discussed earlier, you can add the excess to your medical expenses before subtracting the 7.5% limit. However, if you use the work-related expenses first as medical expenses, you cannot use any part of them to figure your credit.

Records. You should keep records of your work-related expenses. Your records should show the nature of and length of your dependent's or spouse's disability.

Employment Taxes for Household Employers

If you have a household employee you may be subject to:

1) Social Security Tax,
2) Federal Unemployment Tax, and
3) Federal Income Tax Withholding.

Social security tax (FICA) is withheld from the employee's pay and matched by the employer. Federal unemployment tax (FUTA) is paid by the employer only and is for the employee's unemployment insurance. Federal income tax is withheld from the employee's total pay if the employee asks you to do so and you agree.

A babysitter or companion you get through a sitter placement agency to come to your home to care for a child or an elderly or disabled person is not your employee if the agency sets the fee and exercises control over the sitter, such as requiring regular reports and providing rules of conduct and appearance. You do not have to pay employment taxes on the amount you pay. But if an association merely gives you a list of sitters and you hire a sitter from that list, the sitter may be your employee.

Social Security (FICA) Tax

If you pay a household employee cash wages of $50 or more during a calendar quarter, those wages are subject to social security tax. Payments in kind (meals, transportation, etc.) are not used to figure the $50 amount or to figure the tax. The tax is figured on all cash wage payments in the quarter, regardless of when they were earned.

Both you and the employee pay a share of the social security tax on the employee's wages. For 1988 and 1989 the social security tax rate for each of you is 7.51%. Therefore, in 1988 you should have deducted 7.51% from each cash wage payment you made during a calendar quarter, if you paid the employee $50 or more during the quarter. The combined rate for you and the employee is 15.02% (7.51% plus 7.51%). The tax applies to the first $45,000 you paid each employee during calendar year 1988 ($48,000 for 1989).

You must pay the total tax yourself if you do not deduct the employee's share from his or her wages. Any of the employee's share you pay is added income to the employee. This income must be included in box 10, *Wages, tips, other compensation,* on Form W-2, *Wage and Tax Statement,* but do not count it as cash wages for social security purposes. You must also include the employee social security tax you pay in box 11 of the employee's Form W-2, even though the tax was not actually withheld.

You report and pay the social security tax quarterly on Form 942, *Employer's Quarterly Tax Return for Household Employees.* The form has instructions for filling it out and a table to determine how much to deduct from the employee's wages.

Income Tax Withholding

If your household employee requests income tax withholding, and you agree, you must withhold an amount from each payment based on the information given to you by the employee and shown on Form W-4, *Employee's Withholding Allowance Certificate.* Publication 15, *Circular E, Employer's Tax Guide,* explains how to figure the amount to withhold.

Earned income credit advance payment. You must make advance payments of the earned income credit to an eligible employee who requests it. Employees who earn under $18,576 in 1988 ($19,340 in 1989) and meet certain other conditions are eligible. The employee makes the request by giving you a completed Form W-5, *Earned Income Credit Advance Payment Certificate.* Each payday, you make the payments to your employee from the social security taxes and withheld income taxes that you would otherwise pay to the Internal Revenue Service. For more information, see Publication 15.

You must notify any employees not having federal income tax withheld that they may be eligible for an income tax refund because of the earned income credit. For more information, see the instructions for Form 942.

Filing Form 942. You must report on Form 942 the taxes withheld each quarter if:

1) You are liable for social security tax, or
2) Your employee asked you to withhold federal income tax and you agreed.

If you own a business as a sole proprietor, you may include your household employee on Form 941, *Employer's Quarterly Federal Tax Return.* Do ***not*** include your household employees on a Form 941 filed for a partnership or corporation.

When to file. File starting with the first quarter in which you:

1) Pay wages subject to social security tax, or
2) Withhold income tax if requested by your employee.

Due Dates for Returns

Quarter	Ending	Due Date
Jan.-Feb.-Mar.	Mar. 31	Apr. 30
Apr.-May-June	June 30	July 31
July-Aug.-Sept.	Sept. 30	Oct. 31
Oct.-Nov.-Dec.	Dec. 31	Jan. 31

If the due date for filing a return falls on a Saturday, Sunday, or a legal holiday, you may file the return on the first day afterward that is not a Saturday, Sunday, or legal holiday.

For more information about employment taxes for household employers, see the instructions for Form 942.

Federal Unemployment Tax (FUTA)

Federal unemployment tax is for your employee's unemployment insurance. If you paid cash wages of $1,000 or more to household employees in any calendar quarter in the current or prior year, you are liable for FUTA tax for any employees you have in the current year. However, the FUTA tax does not apply to wages paid to your spouse, to your parents, or to your children under 21 years old.

Rate. The rate is 6.2% on the first $7,000 of cash wages paid to each employee during the calendar year.

The FUTA tax is imposed on you as the employer. You must not collect or deduct it from the wages of your employees.

You can take a credit against your federal unemployment tax for the unemployment tax you pay to the state. Your net federal tax may be as low as 0.8%, if you pay the state tax on time.

When you hire a household employee, you should contact your state employment tax office to get information on how to file the state return and to get a state reporting number. The state will give you your experience rate, which you use to figure the amount of tax you will pay the state.

You must file an annual return on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return,* by January 31 following the close of the calendar year for which the tax is due. Any tax still due must be paid with the return.

Usually, the Internal Revenue Service will mail Form 940 to you. However, if you do not receive it, get one in time to file.

For more information, see Publication 926, *Employment Taxes for Household Employers,* and the instructions to Form 940.

Form **2441**

Department of the Treasury
Internal Revenue Service

Credit for Child and Dependent Care Expenses

▶ Attach to Form 1040.
▶ See instructions below.

OMB No. 1545-0068
1988
Attachment Sequence No. **23**

Name(s) as shown on Form 1040: John M. and Peggy A. Harris

Your social security number: 135 00 2468

Note: *If you paid cash wages of $50 or more in a calendar quarter to an individual for services performed in your home, you must file an employment tax return. Get* ***Form 942*** *for details.*

1	Enter number of qualifying persons who were cared for in 1988. (See instructions for definition of qualifying persons.) ▶ ***Caution:*** *To qualify, the person(s)* ***must*** *have shared the same home with you in 1988.*	1	2
2	Enter the amount of **qualified** expenses you incurred and actually paid in 1988 for the care of the qualifying person. (See **What Are Qualified Expenses?** in the instructions.) **Do not** enter more than $2,400 ($4,800 if you paid for the care of two or more qualifying persons)	2	3,000
3a	You **must** enter your earned income on line 3a. See line 3 instructions for definition of earned income	3a	35,000
b	If you are married, filing a joint return for 1988, you must enter your spouse's earned income on line 3b. (If spouse is a full-time student or is disabled, see the line 3 instructions for amount to enter.)	3b	2,400
c	If you are married filing a joint return, compare the amounts on lines 3a and 3b, and enter the **smaller** of the two amounts on line 3c	3c	2,400
4	• If you were unmarried at the end of 1988, compare the amounts on lines 2 and 3a, and enter the **smaller** of the two amounts on line 4. • If you are married filing a joint return, compare the amounts on lines 2 and 3c, and enter the **smaller** of the two amounts on line 4.	4	2,400
5	Enter decimal amount from table below that applies to the adjusted gross income on Form 1040, line 31	5	× .20

If line 31 is: Over—	But not over—	Decimal amount is:	If line 31 is: Over—	But not over—	Decimal amount is:
$0	10,000	.30	$20,000	22,000	.24
10,000	12,000	.29	22,000	24,000	.23
12,000	14,000	.28	24,000	26,000	.22
14,000	16,000	.27	26,000	28,000	.21
16,000	18,000	.26	28,000		.20
18,000	20,000	.25			

6	Multiply the amount on line 4 by the decimal amount on line 5, and enter the result	6	480
7	Multiply any child and dependent care expenses for 1987 that you paid in 1988 by the percentage that applies to the adjusted gross income on your 1987 Form 1040, line 31, or Form 1040A, line 13. Enter the result. (See line 7 instructions for the required statement.)	7	
8	Add amounts on lines 6 and 7. See the worksheet in the instructions for line 8 for the amount of credit you can claim	8	480

General Instructions

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to ensure that taxpayers are complying with these laws and to allow us to figure and collect the right amount of tax. You are required to give us this information.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	20 minutes
Learning about the law or the form	11 minutes
Preparing the form	16 minutes
Copying, assembling, and sending the form to IRS	17 minutes

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to either IRS or the Office of Management and Budget at the addresses listed in the instructions of Form 1040.

What Is the Child and Dependent Care Expenses Credit?

You may be able to take this credit if you paid someone to care for your child or other qualifying person so you could work or look for work in 1988. The credit may be as much as $720 ($1,440 if two or more qualifying persons were cared for).

Additional information.—For more details, please get **Pub. 503,** Child and Dependent Care Credit.

Who Is a Qualifying Person?

A qualifying person is:

- Any person under age 15 whom you claim as a dependent (but see **Children of divorced or separated parents**).
- Your disabled spouse who is mentally or physically unable to care for himself or herself.
- Any disabled person who is mentally or physically unable to care for himself or herself and whom you claim as a dependent, or could claim as a dependent except that he or she had income of $1,950 or more.

Children of divorced or separated parents.—If you were divorced, legally separated, or lived apart from your spouse during the last 6 months of 1988, you may be able to claim the credit even if your child is not your dependent. If your child is not your dependent, he or she is a qualifying person if **all five** of the following apply:

1. You had custody of the child for the longer period during the year; and

2. The child received over half of his or her support from one or both of the parents; and

3. The child was in the custody of one or both of the parents over half of the year; and

4. The child was under age 15, or was physically or mentally unable to care for himself or herself; and

5. The child is not your dependent because—

a. As the custodial parent, you have signed **Form 8332,** or a similar statement, agreeing not to claim the child's exemption for 1988; or

b. You were divorced or separated before 1985 and your divorce decree or written agreement states that the other parent can claim the child's exemption, and the other parent provides at least $600 in child support during the year. **Note:** *This rule does not apply if your decree or agreement was changed after 1984 to specify that the other parent cannot claim the child's exemption.*

Who May Take the Credit?

To claim the credit, **all five** of the following must apply:

(Continued on back)

34. Credit for the Elderly or the Disabled

This chapter explains how to figure the credit for the elderly or the disabled. The maximum credit available is $1,125. You may claim this credit if you are age 65 or older, or retired on disability and were permanently and totally disabled when you retired.

The credit is generally not available to you if your income is high enough to require you to report any part of your social security or tier 1 railroad retirement benefits as taxable income.

You **must** file Form 1040 to claim the credit. You figure the credit on Schedule R, *Credit for the Elderly or the Disabled.*

The Internal Revenue Service will figure your credit. If you choose to have the Internal Revenue Service figure your tax on Form 1040, and you qualify for the credit for the elderly or the disabled, the Service will figure the credit for you. See *Tax Figured by IRS* in Chapter 31.

Can You Take the Credit?

You can take the credit for the elderly or the disabled if you are a qualified individual.

Qualified Individual

You are a qualified individual for this credit if you are a U.S. citizen or resident and:

1) You are age 65 or older by the end of the tax year, or
2) You are under age 65 at the end of the tax year, and
   a) You are retired on permanent and total disability,
   b) You did not reach mandatory retirement age before 1988, and
   c) You received taxable disability benefits in 1988.

Age 65. You are considered 65 on the day before your 65th birthday. Therefore, you are 65 by the end 1988 if your 65th birthday is on January 1, 1989.

Mandatory retirement age is the age set by your employer at which you must retire.

U.S. citizen or resident. You must be a U.S. citizen or resident to claim the credit. Generally, you may not claim the credit if you were a nonresident alien at any time during the tax year. However, if you are a nonresident alien who is married to a U.S. citizen or resident at the end of the tax year and you choose to be treated as a U.S. resident and be taxed on your worldwide income, you may claim the credit.

Also, if you were a nonresident alien at the beginning of the year and a resident at the end of the year, and you were married to a U.S. citizen or resident at the end of the year, you may choose to be treated as a U.S. resident for the entire year and thus be allowed to claim the credit. For information on these choices, see Publication 519, *U.S. Tax Guide for Aliens.*

Qualified Individual Under Age 65

If you are under 65, you may qualify for the credit only if you are retired on permanent and total disability.

You are considered retired, even if you do not retire formally, when you have stopped working because of your disability. You are retired on permanent and total disability if you meet all of the following conditions:

- You were permanently and totally disabled when you retired,
- You are still permanently and totally disabled, and
- You receive disability income because of the disability.

If you retired on disability before 1977, you did not have to be permanently and totally disabled at the time you retired, provided you were permanently and totally disabled on January 1, 1976, or January 1, 1977.

Permanent and total disability. You are permanently and totally disabled if you cannot engage in any substantial gainful activity because of your physical or mental condition. A physician must find that the condition has lasted or can be expected to last continuously for 12 months or more, or that the condition can be expected to lead to death.

Substantial gainful activity. You are engaged in substantial gainful activity if you work performing significant duties over a reasonable period of time for pay or profit, or if the work you do generally is done for pay or profit.

Regular work in a full-time, or part-time, competitive work situation for at least the minimum wage conclusively shows that you are able to engage in a substantial gainful activity. Minimum wage is defined by the Fair Labor Standards Act.

Substantial gainful activity is not work you do to take care of yourself or your home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. But, the kind of work you do may show that you are able to engage in substantial gainful activity. The fact that you have not worked for some time is not, of itself, conclusive evidence that you cannot engage in substantial gainful activity.

Example 1. Sue, a sales clerk, retired on disability. She is 53 years old and now works as a full-time babysitter for a rate of pay equal to the minimum wage. Even though Sue is doing different work, she is able to do the duties of her new job in a full-time competitive work situation for pay that is equal to the minimum wage. She is able to engage in substantial gainful activity and, therefore, cannot take the credit.

Example 2. Tom, a bookkeeper, retired on disability. He is 59 years old and now drives a truck for a charitable organization. He sets his own hours and is not paid. Duties of this nature generally are performed for pay or profit. Some weeks he works 10 hours and some weeks he works 40 hours. Over the year he averages 20 hours a week. The kind of work and his average hours a week conclusively show that Tom is able to engage in substantial gainful activity. This is true even though Tom is not paid and he sets his own hours. He cannot take the credit.

Example 3. John, who retired on disability, took a job with a former employer on a trial basis. The purpose of the job was to see if John could do the work. The trial period lasted for 6 months during which John was paid the minimum wage. Because of John's disability, he was assigned only light duties of a nonproductive "make-work" nature. The activity was gainful because John was paid at least the minimum wage. But the activity was not substantial because his duties were nonproductive. These facts do not, by themselves, show that John is able to engage in substantial gainful activity.

Example 4. Joan, who retired on disability from employment as a bookkeeper, lives with her sister who manages several motel units. Joan assisted her sister for one or two hours a day by performing duties such as washing dishes, answering phones, registering guests, and bookkeeping. Joan can select the time during the day when she feels most fit to perform the tasks undertaken. Work of this nature, performed off and on during the day at Joan's convenience, is not activity of a "substantial and gainful" nature even if she is paid for the work. The performance of these duties does not, of itself, show that Joan is able to engage in substantial gainful activity.

Disability income. Disability income is the total amount you are paid under your employer's accident and health plan or pension plan that is included in your income as wages or payments in lieu of wages for the time you are absent from work because of permanent and total disability. However, any payment you receive from a plan that does not provide for disability retirement is not disability income. Also, any lump-sum payment for accrued annual leave that you receive when you retire on disability is a salary payment and is not disability income. For the credit, disability income does ***not*** include any amount you receive from your employer's pension plan after you reach mandatory retirement age. For more information on disability income, see Chapter 11.

Doctor's statement. If you are under 65, a doctor must certify that you are permanently and totally disabled. You must complete Part II of Schedule R (Form 1040). However, the "Physician's Statement" does not have to be completed this year if:

1) Due to your continued disability you were unable to engage in any substantial gainful activity in 1988, and
2) You filed a statement in an earlier year. The statement must have met one of these two conditions:
   - If filed for a tax year before 1984, it must have been for the same disability, or
   - If filed for a tax year after 1983, the doctor must have checked box B of the statement.

If you have not filed a doctor's statement in a previous year, or if the statement you filed did not meet one of these conditions, your doctor must complete the statement.

If the Veterans' Administration (VA) certifies that you are permanently and totally disabled, you can file Form 6004 instead of the physician's statement. Form 6004 must be signed by a person authorized by the VA to do so. You can get Form 6004 from the VA.

Married Taxpayers

Generally, if you are married at the end of the tax year, you and your spouse must file a joint return to claim the credit. If you and your spouse did not live in the same household at any time during the tax year, you may file either a joint return or separate returns and still take the credit.

If you are married, living with your child and apart from your spouse, you may be considered unmarried. See *You are considered unmarried,* under *Head of Household,* in Chapter 2, for the tests you must meet.

Figuring the Credit

If you want the Internal Revenue Service to figure your tax and credits, including the credit for the elderly or the disabled, see *Tax Figured by IRS* in Chapter 31.

If you figure the credit yourself on Schedule R, you must:

1) Determine the ***base amount*** you may use, and
2) Reduce that base amount by—
    a) Any ***nontaxable social security*** and other nontaxable pensions and disability benefits you received, and
    b) Part of your ***adjusted gross income,*** depending on the level of your income.

The credit is 15% of the amount determined to be your base amount reduced by the items shown in (2) above.The steps to determine these amounts are explained in the following sections. In certain cases, the amount of your credit may be limited. See *Limitation on Credit,* later.

Base Amount

To figure the credit, you must first determine your base amount. If you are a qualified individual under age 65, your base amount cannot be more than your taxable disability income for the tax year. See *Under age 65,* later.

The base amount used to figure your credit is—

$5,000 if you are a qualified individual who is single, a head of household, or a qualifying widow or widower.

$5,000 if you are married filing a joint return and only one of you is a qualified individual.

$7,500 if you are married filing a joint return and both of you are qualified individuals.

$3,750 if you are a qualified individual who is married filing a separate return and you and your spouse did not live in the same household at any time during the tax year.

Under age 65. If you are a qualified individual under age 65 and you have disability income, defined earlier, of less than $5,000, your base amount is limited to the amount of your disability income. If you are married filing a joint return and both you and your spouse are qualified individuals under age 65, and the total disability income for both of you is less than $7,500, your base amount is limited to the total disability income for both of you. If you are married filing a joint return and one of you is age 65 or older and the other is a qualified individual under age 65, your base amount is $5,000 plus the disability income of the spouse under age 65, but not more than $7,500.

Nontaxable Social Security

Once you have determined your base amount, you must reduce it by the total amount of nontaxable social security and certain other nontaxable payments (covered later) you receive during the year. If you are married filing a joint return, you must reduce your base amount by the total amount of nontaxable payments both you and your spouse receive. You figure the amount of the nontaxable payments on line 13 of Schedule R.

Use the worksheet in the Form 1040 instructions to determine if any part of your social security benefits (or equivalent railroad retirement benefits, if applicable) are taxable. The nontaxable portions are used to reduce your base amount.

Reduce the base amount used to figure your credit by the total amount of the following—

Social security payments that are not taxed. This includes the gross amount of nontaxable social security benefits, including disability benefits, before deducting any amounts that are withheld to pay premiums on supplementary Medicare insurance, and before any reduction because of receipt of a benefit under workers' compensation. Do not include a lump-sum death benefit payment you may receive as a surviving spouse, or a surviving child's insurance benefit payments you may receive as a guardian. If you are married filing a separate return and either you or your spouse or both of you live in a community property state, your social security benefits will be your separate property.

Social security equivalent part of tier 1 railroad retirement pension payments that are not taxed.

Nontaxable pension or annuity payments or disability benefits that are paid under a law administered by the Veterans Administration. Do not include amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability annuity under section 808 of the Foreign Service Act of 1980.

Pension or annuity payments or disability benefits that are excluded from income under any provision of federal law other than the Internal Revenue Code.

Community property. Married persons living apart and not filing a joint return may be able to disregard certain community property laws when figuring the credit. If either you or your spouse or both are domiciled in a community property state, see *Spouses Living Apart* in Publication 555, *Community Property and the Federal Income Tax,* for more information. In applying the rules discussed in Publication 555, treat your retirement and disability pay, other than social security and equivalent railroad retirement benefits, as earned income. Social security and equivalent railroad retirement benefits are not community income.

Adjusted Gross Income Limit

You must reduce the base amount used to figure your credit by one-half of the amount of your adjusted gross income (line 32 of Form 1040) that is more than—

$7,500 if you are single, a head of household, or a qualifying widow or widower, or

$10,000 if you are married filing a joint return, or

$5,000 if you are married filing a separate return and you and your spouse did not live in the same household at any time during the tax year.

The result is your excess adjusted gross income. You figure your excess adjusted gross income on lines 14 through 17 of Schedule R.

You will not be able to claim the credit on Schedule R if—

You are single, a head of household, or a qualifying widow or widower and receive nontaxable social security or other nontaxable pensions or disability benefits of $5,000 or more, or have adjusted gross income of $17,500 or more.

You are married filing a joint return, only one spouse is a qualified individual, and together you receive nontaxable social security or other nontaxable pensions or disability benefits of $5,000 or more, or have adjusted gross income of $20,000 or more.

You are married filing a joint return, both of you are qualified individuals, and together you receive nontaxable social security or other nontaxable pensions or disability benefits of $7,500 or more, or have adjusted gross income of $25,000 or more.

You are married filing a separate return and you and your spouse did not live in the same household at any time during the tax year, and you receive nontaxable social security or other nontaxable pensions or disability benefits of $3,750 or more, or have adjusted gross income of $12,500 or more.

Note: If your base amount is limited to your disability income, the amount of income that will keep you from taking the credit will be less than the amounts listed above. See *Base Amount,* earlier.

In addition, you will not be able to claim the credit if the total of your nontaxable social security or other nontaxable pensions or disability benefits plus your excess adjusted gross income on line 17 of Schedule R equals or is more than your base amount.

Example. You are 66 years old and your spouse is 64. Your spouse is not disabled. You file a joint return on Form 1040. Your adjusted gross income is $14,630. Together you received $3,200 from social security, which was nontaxable. You figure the credit as follows:

Base amount		$5,000
Subtract the total of:		
Social security and other nontaxable pensions	$3,200	
Excess adjusted gross income [($14,630 − $10,000) ÷ 2]	2,315	5,515
Balance (Not less than -0-)		-0-
Credit		-0-

You may not take the credit since your nontaxable social security plus your excess adjusted gross income is more than your base amount.

Limitation on Credit

Your credit may be limited if:

1) You file Schedule C, D, E, or F (Form 1040), and
2) Your total income (line 23, Form 1040) plus tax-exempt interest from private activity bonds issued after August 7, 1986 (reported on line 8b, Form 1040), plus any net operating loss deduction (reported on line 22, Form 1040) is more than $30,000 if single or head of household; $40,000 if married filing jointly or qualifying widow or widower; or $20,000 if married filing separately.

If you do not meet both of these conditions, your credit is ***not*** subject to the limit. If you meet both conditions, you must complete Form 6251, *Alternative Minimum Tax—Individuals*, to determine your tentative minimum tax (before the alternative minimum tax foreign tax credit). The amount of your credit will be limited to the smaller of:

1) Your credit as computed, or
2) Your regular tax less:
    a) Any credit for child and dependent care expenses, and
    b) Any amount shown on line 15, Form 6251.

Schedule R

If you qualify for the credit, complete Schedule R, as discussed earlier, and attach it to your Form 1040 when you file your return. There are separate instructions available for this schedule, which you should use to help you complete it.

If you want the Service to figure your credit, see *Form 1040*, under *Tax Figured by IRS* in Chapter 31.

Examples

The following examples illustrate the credit for the elderly or the disabled. Assume that none of the taxpayers in these examples had to file a Form 6251.

Example 1. John Ash is single and 68 years old. He received the following income for the year:

Social security received	$3,120
Interest (taxable)	215
Pension (taxable part)	3,600
Wages from a part-time job	4,245

John's adjusted gross income is $8,060 ($4,245 + $3,600 + $215). The social security benefits are nontaxable. John figures the credit as follows:

Base amount		$5,000
Subtract the total of:		
Social security and other nontaxable pensions	$3,120	
Excess adjusted gross income [($8,060 − $7,500) ÷ 2]	280	3,400
Balance		$1,600
Credit (15% of $1,600)		$ 240

John's credit is $240. He shows this amount on line 42 of Form 1040.

Example 2. You are age 58 and single. Two years ago you retired on permanent and total disability and you are still permanently and totally disabled. You filed the required physician's statement with your return for the year you retired on disability, so you check the box in Part II of Schedule R. This year you received nontaxable social security disability benefits of $3,000, a taxable disability pension of $8,400, and $100 interest. Your adjusted gross income is $8,500 ($8,400 + $100). You figure your credit for the elderly or the disabled as follows:

Base amount		$5,000
Taxable disability pension		$8,400
Smaller of these amounts		$5,000
Subtract the total of:		
Nontaxable disability benefits	$3,000	
Excess adjusted gross income [($8,500 − $7,500) ÷ 2]	500	3,500
Balance		$1,500
Credit (15% of $1,500)		$ 225

Your credit is $225. Enter $225 on line 42 of Form 1040.

Example 3. Bill White is 45. His wife, Helen, is 41. Bill had a stroke in 1984 and retired on permanent and total disability. He is still permanently and totally disabled because of the stroke. In November of this year, Helen was injured in an accident at work and retired on permanent and total disability.

Bill received nontaxable social security disability benefits of $3,000 this year and a taxable disability pension of $6,000. Helen earned $9,200 from her job and received a taxable disability pension of $1,000. Their joint return shows adjusted gross income of $16,200 ($6,000 + $9,200 + $1,000).

Helen got her doctor to complete Part II of Schedule R. Bill had filed a physician's statement with their return for the year he had the stroke, so he does not have to file another physician's statement this year. He checks the box in Part II.

Bill and Helen use Schedule R to figure their $135 credit for the elderly or the disabled. They enter this amount on line 42 of Form 1040. See their filled-in Schedule R in this chapter.

Schedule R
(Form 1040)
Department of the Treasury
Internal Revenue Service

Credit for the Elderly or the Disabled

▶ **For Paperwork Reduction Act Notice, see Form 1040 Instructions.**
▶ **Attach to Form 1040.** ▶ **See separate Instructions for Schedule R.**

OMB No. 1545-0074
1988
Attachment Sequence No. **17**

Name(s) as shown on Form 1040	Your social security number
Bill M. and Helen A. White	135 : 00 : 7911

You may be able to use Schedule R to reduce your tax if by the end of 1988:

- You were 65 or older, **OR**
- You were under 65, you retired on **permanent and total** disability, and you received taxable disability income.

Even if one of the situations described above applies to you, you must meet other tests to be able to take the credit on Schedule R. See th separate Schedule R Instructions for details.

Note: *In most cases IRS can figure this credit for you. See page 16 of the Form 1040 Instructions.*

Part I Check the Box That Applies to Your Filing Status and Age (Check only one box)

If your filing status is:	**And by the end of 1988:**	**Check box:**
Single*	1 You were 65 or older	1 ☐
	2 You were under 65 and you retired on permanent and total disability	2 ☐
* Includes Head of household and Qualifying widow(er) with dependent child		
Married filing a joint return	3 Both spouses were 65 or older	3 ☐
	4 Both spouses were under 65, but only one spouse retired on permanent and total disability	4 ☐
	5 Both spouses were under 65, and both retired on permanent and total disability	5 ☒
	6 One spouse was 65 or older, and the other spouse was under 65 and retired on permanent and total disability	6 ☐
	7 One spouse was 65 or older, and the other spouse was under 65 and **NOT** retired on permanent and total disability	7 ☐
Married filing a separate return	8 You were 65 or older, and you did not live with your spouse at any time in 1988	8 ☐
	9 You were under 65, you retired on permanent and total disability, and you did not live with your spouse at any time in 1988	9 ☐

Note: *If you checked the box on line 1, 3, 7, or 8, skip Part II and complete Part III. If you checked the box on line 2, 4, 5, 6, or 9, complete Parts II and III.*

Part II Statement of Permanent and Total Disability (Complete only if you checked the box on line 2, 4, 5, 6, or 9 above)

IF: 1 You filed a physician's statement for this disability for 1983 or an earlier year, or you filed a statement for tax years after 1983 and your physician checked Box B on the statement, **AND**

2 Due to your continued disabled condition you were unable to engage in any substantial gainful activity in 1988, check this box ▶ ☒

If you checked this box, you do not have to file another statement for 1988. If you did not check this box, have your physician complete the following statement:

Physician's Statement

I certify that Helen A. White
Name of disabled person

was permanently and totally disabled on January 1, 1976, or January 1, 1977, **OR** was permanently and totally disabled on the date he or she retired. Date retired if retired after December 31, 1976 ▶ November 4, 1988

Physician: Sign your name on **either** line A or B below and check the box to the right of your signature.

	Physician's signature	Date	
A The disability has lasted, or can be expected to last, continuously for at least a year	John F. Doctor	2/7/89	A ☒
B There is no reasonable probability that the disabled condition will ever improve			B ☐

Physician's name	Physician's address
John F. Doctor	101 Green Street, Hometown, MD 20000

Instructions for Statement

Taxpayer

Enter in the space provided the date you retired if you retired after December 31, 1976.

Physician

A person is permanently and totally disabled when—

- He or she cannot engage in any substantial gainful activity because of a physical or mental condition; and
- A physician determines that the disability:
  1. has lasted, or can be expected to last, continuously for at least a year; or
  2. can be expected to lead to death.

(Continued on back)

Schedule R (Form 1040) 1988

Part III Figure the Amount of Your Credit

10 Enter: $5,000 if you checked the box on line 1, 2, 4, or 7 in Part I, **OR**
$7,500 if you checked the box on line 3, 5, or 6 in Part I, **OR**
$3,750 if you checked the box on line 8 or 9 in Part I. **10** 7,500

Caution: *If you checked the box on line 2, 4, 5, 6, or 9 in Part I, you* **MUST** *complete line 11 below. Otherwise, skip line 11 and enter the amount from line 10 on line 12.*

11 Enter on this line your taxable disability income (and also your spouse's if you checked the box on line 5 in Part I) that you reported on Form 1040. However, if you checked the box on line 6 in Part I, enter on this line the taxable disability income of the spouse who was under age 65 **PLUS** $5,000. (For more details on what to include, see the Instructions.) **11** 7,000

12 If you completed line 11 above, compare the amounts on lines 10 and 11, and enter the **smaller** of the two amounts on this line. Otherwise, enter the amount from line 10 on this line **12** 7,000

13 Enter the following pensions, annuities, or disability income that you (and your spouse if you file a joint return) received in 1988 (see Instructions):

a Nontaxable part of social security benefits; and
Nontaxable part of railroad retirement benefits treated as social security. **13a** 3,000

b Nontaxable veterans' pensions; and
Any other pension, annuity, or disability benefit that is excluded from income under any other provision of law. **13b**

c Add lines 13a and 13b. (Even though these income items are not subject to income tax, they **must** be included to figure your credit.) If you did not receive any of the types of nontaxable income listed on line 13a or 13b, enter -0- on line 13c **13c** 3,000

14 Enter the amount from Form 1040, line 32 **14** 16,200

15 Enter: $7,500 if you checked the box on line 1 or 2 in Part I, **OR**
$10,000 if you checked the box on line 3, 4, 5, 6, or 7 in Part I, **OR**
$5,000 if you checked the box on line 8 or 9 in Part I. **15** 10,000

16 Subtract line 15 from line 14. Enter the result. If line 15 is more than line 14, enter -0- **16** 6,200

17 Divide the amount on line 16 by 2. Enter the result **17** 3,100

18 Add lines 13c and 17. Enter the total **18** 6,100

19 Subtract line 18 from line 12. Enter the result. If the result is zero or less, stop here; you **cannot** take the credit. Otherwise, go on to line 21 . . . . **19** 900

20 Percentage used to figure the credit . . . . **20** × .15

21 Multiply the amount on line 19 by the percentage (.15) on line 20 and enter the result. If you do not file Schedule C, D, E, or F (Form 1040), enter the amount from line 21 on Form 1040, line 42. Otherwise, see the instructions to determine if your credit may be further limited **21** 135

35. Other Credits

Important Changes for 1988

Residential energy credit carryforward. For tax years beginning after 1987, you may no longer claim a residential energy credit carryforward.

Earned income credit. For tax years beginning in 1988, if your earned income is less than $18,576 and you have a child who lives with you for more than half the year, you may be entitled to a credit. The credit could be as much as $874.

Minimum tax credit. Beginning in 1988, you may be able to take a minimum tax credit against your regular income tax, if you paid alternative minimum tax for 1987.

In addition to the child and dependent care credit (Chapter 33) and the credit for the elderly or the disabled (Chapter 34), you may be able to claim other tax credits. This chapter discusses some of these other credits.

The chapter is divided into two parts. The first part, *Nonrefundable Credits,* discusses four credits that you subtract directly from your tax. You may claim these credits even if you do not itemize your deductions. They may reduce your tax to zero. If they are more than your tax, the excess is not refunded.

The second part, *Refundable Credits,* covers four credits that are refundable and treated as payments. These four credits are added to the federal income tax withheld from your salary and wages and to any estimated tax payments you made. If the total of these amounts is more than your total tax, the excess will be refunded to you.

Nonrefundable Credits

The following credits are discussed in this part:

Minimum tax credit,
Mortgage interest credit,
Foreign tax credit, and
Alcohol fuel credit.

Minimum Tax Credit

Beginning in 1988, you may be eligible to take a minimum tax credit against your regular income tax, if you paid alternative minimum tax for 1987. The credit is the part of your 1987 alternative minimum tax that was based on adjustments or preference items that defer tax rather than cause a permanent avoidance of tax.

If you cannot use all of your minimum tax credit in 1988, you can carry forward the excess to 1989 and later years until it is used up.

Use Form 8801, *Credit for Prior Year Minimum Tax,* to figure your 1988 credit and any carryforward to 1989.

For additional information about the credit, and an illustrated example, see Publication 909, *Alternative Minimum Tax for Individuals.*

Mortgage Interest Credit

Mortgage credit certificates issued by state and local governments before 1988 entitle a certificate holder to a mortgage interest credit if a certificate is used in connection with the purchase, qualified rehabilitation, or qualified home improvement of the certificate holder's main home.

Who qualifies. You may be able to claim a mortgage interest credit if you were issued a qualified mortgage credit certificate (MCC) under a qualified MCC program and the residence to which the certificate relates is your main home.

Amount of credit. You figure the credit amount by multiplying the certificate credit rate by the amount of interest you paid during the year on the covered loan amount. The certificate credit rate and the covered loan amount are shown on the MCC.

Limitation. If the certificate credit rate is more than 20%, the credit amount cannot be more than $2,000.

Allocation. If two or more persons (other than a married couple filing a joint return) hold an interest in the residence to which the mortgage credit certificate relates, the credit amount must be allocated between them in proportion to the interest held by each person.

Example. John and his brother, George, were issued a qualified MCC. They used the certificate to obtain a mortgage on a home that is their main home. John has a 60% interest in the home and George has a 40% interest.

The MCC shows a credit rate of 25% and a covered loan amount of $60,000, the amount of the mortgage that John and George received. Since John has a 60% interest in the property, his credit amount cannot be more than $1,200 ($2,000 × 60%). The credit amount for George cannot be more than $800 ($2,000 × 40%). John paid $5,400 interest on the mortgage in 1988, and George paid $3,600.

John figures his credit amount by multiplying the interest he paid for the year, $5,400, by the certificate credit rate, 25%, for a total of $1,350. However, the credit amount for John cannot be more than $1,200.

George figures his credit amount by multiplying $3,600 by 25% for a total of $900. However, the credit amount for George cannot be more than $800.

The excess ($150 for John and $100 for George) cannot be carried forward to next year, regardless of John's and George's tax liabilities. See *Carryforward,* next.

Carryforward. If your allowable credit is more than your tax liability reduced by other personal credits, you may carry forward the unused portion of the credit to your next 3 tax years or until used, whichever comes first.

If you are subject to the $2,000 limitation because your certificate credit rate is more than 20%, no amount over the $2,000 (or your prorated share of the $2,000 if you must allocate the credit) may be carried forward.

Reduced interest deduction. If you itemize your deductions on Schedule A, Form 1040, you must reduce the amount of your otherwise allowable home mortgage interest deduction by the amount allowable as a mortgage interest credit. The allowable credit includes your carryforward to next year. For more information about the home mortgage interest deduction, see Chapter 25.

How to claim the credit. Figure the amount of the credit and any carryforward to next year on Form 8396, ***Mortgage Interest Credit,*** and attach it to your Form 1040. Be sure to include any carryforward from 1985, 1986, and 1987. You cannot use a carryforward from 1985 on your tax return for any year after 1988.

Include the amount of the credit in your total for line 46, Form 1040. Enter "MIC" and the amount of the credit on the dotted line next to line 46.

For more information about the mortgage interest credit, see Publication 530, *Tax Information for Homeowners.*

Foreign Tax Credit

You may claim foreign income taxes you paid to a foreign country or U.S. possession as a credit against your U.S. income tax. Or, you may deduct them as an itemized deduction.

To take the foreign tax credit, you must complete Form 1116, *Computation of Foreign Tax Credit,* and attach it to your Form 1040. Enter the amount of the credit on line 43, Form 1040. For more information, see Publication 514, *Foreign Tax Credit for Individuals.*

Alcohol Fuel Credit

You may be able to claim a tax credit for alcohol used in the production of gasohol, used as a fuel in your trade or business, or sold at retail and placed in a fuel tank. The amount of the credit is 45 cents a gallon for alcohol that is at least 150 proof but less than 190 proof and 60 cents a gallon for alcohol that is at least 190 proof. Use Form 6478, *Credit for Alcohol Used as Fuel,* to claim the credit. Check the second box on line 44, Form 1040 (*General business credit*), write in "6478" in the space next to the box, and include the amount of the credit in the total on line 44.

If you claim more than one credit on line 44, or you have a credit carryforward, you must also complete Form 3800 and attach it to Form 1040. Also be sure to check the box on line 44 for Form 3800. For more information, see Form 6478 and its instructions.

Refundable Credits

The following credits are refundable, that is, they are treated as payments of tax:

Earned income credit,
Credit for excess social security tax or railroad retirement tax withheld,
Credit from a regulated investment company, and
Credit on diesel-powered highway vehicles.

Earned Income Credit

You may be entitled to a refundable credit of up to $874 if your earned income and your adjusted gross income are each less than $18,576. Your adjusted gross income is on line 14, Form 1040A, or line 32, Form 1040. Subtract the credit from your tax. If the credit is larger than your tax, the difference will be refunded to you. Even if you are not required to file a return, you should file to get a refund.

If you want the Internal Revenue Service to figure your tax on Form 1040 or Form 1040A and you can take the earned income credit, the Service will also figure the credit for you. See *Tax Figured by IRS* in Chapter 31.

Advance payments. If you think you will be eligible for the earned income credit for 1989, you can choose to get the credit in advance.

The credit will be added regularly to your pay. See the discussion of *Advance Earned Income Credit* in Chapter 5.

Alternative minimum tax. You must reduce the amount of your earned income credit by your alternative minimum tax, if any. See *Alternative minimum tax* under *How to figure the credit*, later.

To be eligible for the credit for 1988:

1) You must have a child living with you for more than half the year (for the whole year if the child is a foster child or if your filing status is qualifying widow(er) with dependent child),
2) Your principal home must be in the United States,
3) You must have earned income during the year,
4) Your earned income and your adjusted gross income must each be less than $18,576,
5) You must not have excluded from your gross income an amount of income that is earned in foreign countries, or claimed a deduction for or excluded a foreign housing amount,
6) Your tax return must cover a full 12 months,
7) Your filing status must be married filing joint return, qualifying widow(er) with dependent child, or head of household, and
8) You usually must file a joint return if you are married. See *Married taxpayers* for an exception.

If you do not qualify for the credit, enter "No" on line 23b of Form 1040A or line 56 of Form 1040.

Married taxpayers. If you are married, you and your spouse usually must file a joint return to claim the credit. However, even though you are married, you may file as a head of household and claim the earned income credit if you meet the tests discussed in Chapter 2 under *Head of Household*.

Your child. If your filing status is ***married filing joint return*** or ***qualifying widow(er)*** with dependent child, your child can be your:

Son,

Daughter,

Stepchild,

Legally adopted child,

Child placed with you by an authorized placement agency for adoption by you, or

Foster child (any other child, such as a grandchild, whom you care for as your own).

You generally must be able to claim an exemption for your child. However, you do not have to claim an exemption for your child if your spouse is not your child's other parent and the child's parent is allowed to claim the exemption under one of the exceptions discussed later.

If your filing status is ***head of household***, your child can be your:

Son,

Daughter,

Stepchild,

Legally adopted child, or

A descendant of your son, daughter, or adopted child.

You do not have to claim an exemption for your child who is unmarried. However, you generally must claim an exemption for your child who is married unless the child's other parent is allowed to claim the exemption under one of the exceptions discussed later.

If during the year you adopted a child, or a child was placed with you for adoption or became your stepchild, the more-than-half-the-year or whole-year home requirement will be satisfied if your home was this child's home from the date the child was adopted, placed with you, or became your stepchild, through the end of the year.

If your child was born, or died, during the year, the more-than-half-the-year or whole-year home requirement will be satisfied if your home was your child's home during the part of the year that your child was alive.

Exceptions. You do not have to claim the exemption if you would be able to claim it except you released your claim in writing to your child's other parent or the exemption was granted to the other parent by a pre-1985 agreement (such as a separation agreement or divorce decree).

A foster child is treated as your child if the foster child lived with you and was a member of your household for the whole year. A foster child is a child whom you care for as your own. A child is not your foster child if the child's natural or adoptive parents provide more than half the child's support for the tax year.

Earned income. Wages, salaries, tips, other employee compensation, net earnings from self-employment, and strike benefits are earned income. Earned income also includes certain disability pensions you received. Earned income includes anything of value (money, goods, or services) you get from your employer for services you performed, regardless of whether it is taxable.

If you have your own business, you must include your net earnings in earned income, even if they are less than $400. You may figure the net earnings from your business by the regular method or the optional method of figuring self-employment tax. If you are eligible to choose the optional method, you may use up to $1,600 as the amount of earned income. See Publication 533, *Self-Employment Tax*, for more information. Your losses from your business reduce earned income.

Income exempt from self-employment tax as a result of the filing and approval of Form 4361 (relating to the clergy) is earned income if it is wages, salaries, tips, or other employee compensation. This includes housing allowances or the rental value of a parsonage that you get as part of your pay for services as an employee.

Income exempt from self-employment tax as a result of the filing and approval of Form 4029 (relating to members of certain religious faiths) is not earned income unless it is wages, salaries, tips, or other employee compensation that is not subject to the election.

Earned income does not include interest, dividends, welfare benefits, veterans benefits, pensions or annuities (other than certain disability pensions), social security payments, workers' compensation, or unemployment compensation. It also does not include taxable scholarships or fellowships not reported on Form W–2.

How to figure the credit. You figure your credit by using the following worksheet and the *Earned Income Credit Table* near the end of this publication.

1) Enter amount from line 7, Form 1040 or Form 1040A, plus any other compensation from your employer, regardless of whether it is taxable .... $____

2) Enter amount of income or (loss) from Schedule SE, line 3 (line 3c if you use the long Schedule SE) .... ____

3) Earned income. Add lines 1 and 2 .... $____

4) Enter the amount of your adjusted gross income from line 32, Form 1040 (line 14, Form 1040A) .... $____

5) If line 4 is ***less than $9,850,*** use the amount from line 3 above to find your credit in the *Earned Income Credit Table*. This is your credit .... $____

6) If line 4 is ***at least $9,850:***
   a) Find the amount from line 3 above in the *Earned Income Credit Table* and enter the credit for that amount here .... $____
   b) Find the amount from line 4 above in the *Earned Income Credit Table* and enter the credit for that amount here .... $____
   c) Enter the smaller of line 6a or line 6b here. This is your credit .... $____

Example. John and Mary Green have a dependent child and are eligible for the earned income credit. John's salary was $10,935. Mary is self-employed and has a loss of $400 from her business. Mary did not use the optional method of figuring self-employment tax. The Greens received $100 interest income. They figure their credit using the worksheet as follows:

1) Enter amount from line 7, Form 1040 or Form 1040A, plus any other compensation from your employer, regardless of whether it is taxable $10,935

2) Enter amount of income or (loss) from Schedule SE, line 3 (line 3c if you use the long Schedule SE) .... (400)

3) Earned income. Add lines 1 and 2 .... $10,535

4) Enter the amount of your adjusted gross income from line 32, Form 1040 (line 14, Form 1040A) $10,635

5) If line 4 is ***less than $9,850,*** use the amount from line 3 above to find your credit in the *Earned Income Credit Table*. This is your credit .... $____

6) If line 4 is ***at least $9,850:***		
a) Find the amount from line 3 above in the *Earned Income Credit Table* and enter the credit for that amount here	$804	
b) Find the amount from line 4 above in the *Earned Income Credit Table* and enter the credit for that amount here	$794	
c) Enter the smaller of line 6a or line 6b here. This is your credit		$ 794

Note. If you received nontaxable compensation from your employer, enter "NEI" on the dotted line to the left of line 56 of Form 1040 or in the space to the left of the line 23b entry space of Form 1040A.

Alternative minimum tax. If you have any alternative minimum tax liability, you must reduce your earned income credit (line 6c above) by the amount of that tax. For more information about the alternative minimum tax, see Chapter 31.

How to claim your credit. To receive your credit, you must file a tax return. Enter your earned income credit on line 56, Form 1040, or line 23b, Form 1040A. If you received any advance earned income credit payments during 1988, you must file a tax return. You should include any advance earned income credit payments in the total on line 53, Form 1040, or line 20, Form 1040A. In the space to the left of the total, write "AEIC" and show the amount of the payments. Your advance payments are shown on your Form W-2.

For more information, see Publication 596, *Earned Income Credit.*

Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld

If any one employer withheld more than $3,379.50 of social security (FICA) tax or more than $5,025.90 of railroad retirement (RRTA) tax in 1988, you may not claim the extra amount as a credit to reduce your income tax. Your employer must adjust this for you.

If you worked for two or more employers during 1988 and together they paid you more than $45,000 ($33,600 if you worked for railroad employers) in wages, too much FICA tax or RRTA tax may have been withheld from your wages. If the total FICA tax and tier 1 RRTA tax withheld was more than $3,379.50, or the total tier 2 RRTA tax withheld was more than $1,646.40, you may claim the extra amount as a credit to reduce your income tax when you file your return.

If you are filing a joint return, you may not add the FICA or RRTA tax withheld from your spouse's income to the amount withheld from yours. Figure the credit separately.

If you did not work for a railroad during the year, figure the credit as follows:

1) Total social security tax withheld by all employers in 1988. (Do not include more than $3,379.50 for any one employer.)	$
2) Total uncollected social security tax on tips, from all 1988 Forms W-2	
3) Total. Add lines (1) and (2)	$
4) Limit	3,379.70
5) Credit. Subtract line (4) from line (3)	$

If you file Form 1040, enter the credit on line 58. If you file Form 1040A or Form 1040EZ, add the credit to the federal income tax that was withheld and report the total on line 23a of Form 1040A or on line 8 of Form 1040EZ. Write "Excess SST" and show the amount of the credit in the space to the left of the line.

Example. You are married, your spouse had no gross income in 1988, and you file a joint return. During 1988 you worked for the Brown Shoe Company and earned $30,000 in wages. Social security (FICA) tax of $2,253.00 was withheld. You also worked for another employer in 1988 and earned $18,000 in wages subject to withholding. $1,351.80 of FICA taxes was withheld from these wages. Because you worked for more than one employer and your total wages were more than $45,000, you may claim a credit of $225.30 for the excess FICA taxes withheld. The $225.30 is the excess of $3,604.80 ($2,253.00 + $1,351.80) over $3,379.50. Enter the $225.30 as a credit against your income tax on line 58, Form 1040, or line 23a, Form 1040A.

If you worked for a railroad and were subject to RRTA tax, you should figure your credit as follows:

1) Total social security and tier 1 railroad retirement tax withheld by all employers in 1988. (Do not include more than $3,379.50 for any one employer.)	$
2) Total uncollected social security and tier 1 railroad retirement tax on tips, from all 1988 Forms W-2	
3) Total. Add lines (1) and (2)	$
4) Limit	3,379.50
5) Subtract line (4) from line (3). (If less than zero, enter zero.)	
6) Total tier 2 railroad retirement tax withheld by all railroad employers in 1988. (Do not include more than $1,646.40 for any one employer.)	
7) Total uncollected tier 2 railroad retirement tax on tips, from all 1988 Forms W-2	
8) Total. Add lines (6) and (7)	$
9) Limit	1,646.40
10) Subtract line (9) from line (8). (If less than zero, enter zero.)	
11) Credit. Add lines (5) and (10)	$

You should use this worksheet if you had railroad retirement tax or both railroad retirement and social security tax withheld during the year.

If you are a railroad employee representative, you may have wages or self-employment income under the social security program, compensation as a railroad employee, or any combination of these. If the total of this income added to your compensation as an employee representative under the railroad retirement program is more than $45,000, do not figure your credit as described. You must figure your credit on Form 4469, *Computation of Excess Medicare Tax Credit,* and include it on line 60, Form 1040. You cannot claim the credit on Form 1040A or Form 1040EZ.

Government employees. The pay of certain federal, state, and local government employees is subject only to the hospital insurance (Medicare) portion of FICA. The tax for this portion is 1.45% of up to $45,000 in wages received during 1988. Therefore, the maximum amount that can be withheld for Medicare in 1988 is $652.50 (1.45% of $45,000).

If during 1988 you received pay from the federal government, a state, or a local government that was subject only to the 1.45% Medicare tax, and either pay from another government job or pay from a job that was subject to FICA or RRTA tax, and your total wages were more than $45,000, you may have had more than the maximum amount of Medicare tax withheld. You can claim the excess as a credit against your income tax.

To claim this credit, use Form 4469, *Computation of Excess Medicare Tax Credit.* Include the credit in the total on Form 1040, line 60, and write "Form 4469" and the amount of the credit on the dotted line next to this total. You cannot claim the credit on Form 1040A or Form 1040EZ.

Credit from a Regulated Investment Company

You must include in your income any amounts that an investment company allocated to you as capital gain dividends, even if you did not actually receive them. If the investment company paid a tax on the capital gain, you are entitled to a refund of this tax since it is considered paid by you. The company will send you Form 2439, telling you the amount of tax paid. You claim the refund by entering the amount on line 60, Form 1040, and attaching Copy B of Form 2439 to your return. See *Capital Gain Distributions* in Chapter 9 for more information on undistributed capital gains.

Credit on Diesel-Powered Highway Vehicles

If you purchased a diesel-powered highway vehicle after January 1, 1985, for a use other than resale, and you are the first owner of the vehicle, you may be entitled to a credit in the year of purchase. The credit is $102 if you purchased a diesel-powered automobile and $198 if you purchased a diesel-powered light truck or van.

To claim the credit or refund, you must complete line 1 of Form 4136, *Computation of Credit for Federal Tax on Fuels,* and attach it to Form 1040. Enter the credit on line 59, Form 1040.

For more information, see the discussion of *Credit or refund on diesel-powered vehicles* in Publication 378, *Fuel Tax Credits and Refunds.*

Part VII
Sample Returns

The three chapters in this part give examples of filled-in tax returns. The first chapter illustrates Form 1040EZ. The second chapter illustrates Form 1040A with the schedule that may need to be filled out and filed with it. The third chapter illustrates Form 1040 with many of the schedules and forms that may need to be filled out and filed with it.

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36. Form 1040EZ

Pat Brown is single and has no dependents. She is 22 years old and a full-time student at State University where she has a scholarship which covers her tuition and $500 of her room and board. Her parents are able to claim her as an exemption. In January of this year, she received her Form W-2 which shows she earned $1,850 in wages and had $250 in federal tax withheld during 1988. She also received a Form 1099–INT showing she had $277 in interest income for 1988. Pat filed Form 1040EZ in 1987, so the IRS sent her the Forms 1040A and 1040EZ tax package. Since she meets all the requirements for using Form 1040EZ (see *Which Form to Use*, in Chapter 1), she decides to use it again for 1988.

To make processing her return quicker and to speed her refund, Pat prints (does not type) her numbers and keeps them inside the boxes on her Form 1040EZ. She does not use dollar signs, and rounds off cents to whole dollars.

Name, Address, and Social Security Number

Pat uses the address label that came with her forms package. The label has her name, address, and social security number. She checks the label to make sure it is correct. However, she does not put the label on her tax return until the return is completed and she is sure it is accurate.

Pat would use the label even if some of the information on it was incorrect. She would make the necessary changes directly on the label and then place it on her completed return.

Presidential Election Campaign Fund. Pat wants one dollar of her taxes to go to this fund, so she checks the "Yes" box. Checking "Yes" will not increase her taxes or reduce her refund.

Report Your Income

Pat has two items of income which must be combined and entered on line 1 of Form 1040EZ. The part of her scholarship that is for room and board ($500) is taxable. She adds this amount to her wages ($1,850) which are shown in Box 10 of her Form W-2. Pat enters the total ($2,350) on line 1. On line 2, she enters her interest income of $277. Pat has no tax-exempt interest, so she does not have to write "TEI" and show any amount to the left of line 2. She adds her wages, taxable scholarship, and interest together to figure her adjusted gross income of $2,627. She enters $2,627 on line 3.

Standard deduction. If Pat could not be claimed as a dependent by her parents or someone else, she would have a standard deduction amount of $3,000.

Since she can be claimed as a dependent by her parents, Pat checks the "Yes" box on line 4. She uses the worksheet on the back of her Form 1040EZ to figure her standard deduction. Her completed worksheet is shown below. She enters the result ($2,350) on line 4.

A. Enter the amount from line 1 on front.	A. 2,350
B. Minimum amount.	B. 500
C. **Compare** the amounts on lines A and B above. Enter the **LARGER** of the two amounts here.	C. 2,350
D. Maximum amount.	D. 3,000
E. **Compare** the amounts on lines C and D above. Enter the **SMALLER** of the two amounts here and on line 4 on front.	E. 2,350

Pat subtracts line 4 ($2,350) from line 3 ($2,627) and enters the result ($277) on line 5.

Personal exemption. Because Pat checked the "Yes" box on line 4, and because her parents can claim her as a dependent on their own tax return, she cannot claim an exemption for herself. She enters 0 (zero) on line 6. If Pat could not be claimed as a dependent by anyone else, she would have been allowed a personal exemption of $1,950.

Pat subtracts line 6 ($0) from line 5 ($277) and enters the result of $277 on line 7. This amount is Pat's taxable income. She will figure her income tax on this amount.

Figure Your Tax

Pat had $250 of income tax withheld from her wages by her employer. She found this amount in Box 9 of her 1988 Form W-2. She enters this amount on line 8 of Form 1040EZ.

Note. If Pat wanted the IRS to compute her tax for her, she would stop at this point. She would make sure lines 1 through 8 were accurately completed, then she would sign and date the return.

Pat decides to compute her tax by herself. She takes the amount on line 7, her taxable income of $277, and goes to the Tax Table. She reads down the income column of the Tax Table until she finds the line that includes her taxable income shown on line 7 of her Form 1040EZ. She then reads across the line to find the single filing status column. The amount shown at the point the income line and the filing status column meet is her tax ($43). She enters this amount of tax on line 9 of her Form 1040EZ.

Refund or Amount You Owe

Pat compares line 8 and line 9. Since line 8 is larger, she subtracts line 9 ($43) from line 8 ($250) to arrive at her refund of $207. She enters this amount on line 10. Pat will receive a tax refund of $207.

If her employer had not withheld any income tax from her wages, Pat would have owed $43 in income tax. She would have been instructed to enter that amount on line 11. She would then attach a check or money order for the full amount of $43, payable to "Internal Revenue Service." She would write on the front of her check or money order:

"1988 Form 1040EZ,"

Her social security number, and

Her daytime telephone number.

Sign Your Return

Pat goes back over her return to make sure she entered the numbers clearly and correctly and that she did the math correctly.

Pat signs and dates her return at the bottom of the form. Now that she has filled in her Form 1040EZ, she takes her pre-printed name and address label from the front of her forms package and places it in the address portion at the top of her return. She attaches Copy B of her Form W-2 to the location indicated on the front of Form 1040EZ.

She makes a copy of her filled-in tax return for her records. Then she mails her return to the Service Center in the envelope that came with her forms package.

A filled-in copy of Pat's return follows.

Filled-in Form 1040EZ

If you need more information, turn to the page shown in the circle.

Department of the Treasury - Internal Revenue Service

Form **1040EZ** **Income Tax Return for Single filers with no dependents** **1988** OMB No. 1545-0675

Name & address Use the IRS mailing label. If you don't have one, please print.

⑫
PB 571-00-4684 DO 54 1
PAT A. BROWN
3408 UNION ST
HOMETOWN, MD 21214

IRS

Please print your numbers like this: 0 1 2 3 4 5 6 7 8 9

Your social security number ☐☐☐ ☐☐ ☐☐☐☐

Please read the instructions on the back of this form. Also, see page 13 of the booklet for a helpful checklist.

⑬ **Presidential Election Campaign Fund** Do you want $1 to go to this fund? *Note: Checking "Yes" will not change your tax or reduce your refund.* ▶ Yes ☒ No ☐

Report your income

Attach Copy B of Form(s) W-2 here

Note: You must check Yes or No.

			Dollars	Cents
㊴ ㊻ 1	Total wages, salaries, and tips. This should be shown in Box 10 of your W-2 form(s). (Attach your W-2 form(s).)	1	2,350	00
㊼ 2	Taxable interest income of $400 or less. If the total is more than $400, you cannot use Form 1040EZ.	2	277	00
3	Add line 1 and line 2. This is your **adjusted gross income.**	3	2,627	00
(120) 4	Can your parents or someone else claim you on their return? ☒ **Yes.** Do worksheet on back; enter amount from line E here. ☐ **No.** Enter 3,000 as your standard deduction.	4	2,350	00
5	Subtract line 4 from line 3. If line 4 is larger than line 3, enter 0.	5	277	00
(154) 6	If you checked the "Yes" box on line 4, enter **0**. If you checked the "No" box on line 4, enter **1,950**. This is your **personal exemption**.	6	0	00
7	Subtract line 6 from line 5. If line 6 is larger than line 5, enter 0. This is your **taxable income.**	7	277	00

Figure your tax

(154) 8	Enter your Federal income tax withheld from Box 9 of your W-2 form(s).	8	250	00
9	Use the **single** column in the tax table on pages 37-42 of the Form 1040A/1040EZ booklet to find the **tax** on the amount shown on **line 7** above. Enter the amount of tax.	9	43	00

Refund or amount you owe

Attach tax payment here

⑮ 10	If line 8 is larger than line 9, subtract line 9 from line 8. Enter the **amount of your refund.**	10	207	00
⑯ 11	If line 9 is larger than line 8, subtract line 8 from line 9. Enter the **amount you owe.** Attach check or money order for the full amount, payable to "Internal Revenue Service."	11		

Sign your return

I have read this return. Under penalties of perjury, I declare that to the best of my knowledge and belief, the return is true, correct, and complete.

⑬ Your signature: Pat A. Brown Date: 2-15-89

For IRS Use Only—Please do not write in boxes below.

Form **1040EZ**

37. Form 1040A

Don and Jean Smith are a married couple with two young children. Don works full time as a carpenter. He was laid off for a few weeks during 1988 and received unemployment compensation. Jean works full time as a secretary. Their four-year-old son, Todd, goes to nursery school while they are at work. Their seven-year-old daughter, Lynn, stays with a neighbor before and after school.

The Smiths filed Form 1040A in 1987 so the IRS sent them the Forms 1040A and 1040EZ tax package this year. Since they meet all the requirements for using Form 1040A (see *Which Form to Use*, in Chapter 1), they decide to use it again in 1988.

Step 1—Name, Address, and Social Security Number

Don and Jean use the label that came with their forms package. The label has their names, address, and social security numbers. They check the label to make sure it is correct, but they do not put it on the return until they have completed and checked the return to make sure it is accurate. If they use the label, their tax return can be processed faster.

The Smiths should use the label even if some of the information on it is incorrect. They would make any necessary changes directly on the label.

Presidential Election Campaign Fund. Don and Jean each want $1 of their taxes to go to this fund. They check both "Yes" boxes. Checking "Yes" does not increase their tax or reduce their refund.

Step 2—Filing Status

Don and Jean must choose their filing status before they figure their tax liability.

Filing status (lines 1–5). Don and Jean check the box on line 2 to file a joint return. Because they are married and living together they must file a joint return in order to claim the child care credit.

Step 3—Exemptions

Don and Jean must indicate the number of exemptions they can claim.

Exemptions (lines 6a–e). Don and Jean can take two personal exemptions, one for each of them. They check these exemptions in the boxes on lines 6a and 6b and enter the total (2) on the line at the right. On line 6c, they write their children's names and enter "2" on the line at the right.

Since Lynn is age 5 years or older, they write her social security number in column 3. Since Todd was not yet 5 years or older at the end of 1988, they check the box by his name in column 2. They write their children's relationship to them (daughter and son) in column 4 and enter "12" (the number of months each child lived with them) in column 5 for each child. They do not have any other dependents, so in the box on line 6e they enter "4" as the total number of exemptions.

Step 4—Total Income

Income, such as wages, interest, dividends, and unemployment compensation is reported on **lines 7–10.**

Wages (line 7). Don's Form W-2, *Wage and Tax Statement*, shows he earned $19,250 last year. Jean's Form W-2 shows she earned $15,155. They find these amounts in Box 10 of their Forms W-2. They add the amounts together and put the total, $34,405, on line 7.

Interest income (lines 8a–b and Part II of Schedule 1). Don and Jean received a statement (Form 1099–INT) from their bank showing they earned $410 of taxable interest income last year. Since their interest income is over $400, they must list the name of the bank and the amount received in Part II of Schedule 1. They also enter this amount on line 8a. They also received $35 of tax-exempt interest from a municipal bond. They enter $35 on line 8b. This amount does not increase their taxable income.

Dividends (line 9). Don and Jean opened an account in a mutual fund last year. They received a statement from the fund showing they earned dividends of $20. They also received a statement from the XYZ Corporation showing they earned dividends of $80 last year. Because the total amount of their dividends is not over $400, they do not have to list them in Part III of Schedule 1. They enter the total amount of their dividends, $100, on line 9.

Unemployment compensation (line 10). Don was laid off for ten weeks in 1988. His state sent him a Form 1099–G, *Statement for Recipients of Certain Government Payments*, showing he received $1,010 in unemployment compensation during this period. He enters this amount on line 10.

Total (line 11). In addition to the Form 1099–G Don received for his unemployment compensation, Don and Jean also received a Form 1099–G from their state showing a tax refund they received in 1988. Because they did not itemize deductions on their federal return in 1987, they do not have to report the refund as income in 1988. Therefore, their total income is the sum of the amounts shown on lines 7, 8a, 9, and 10. Don and Jean add these lines and enter the total, $35,925, on line 11.

Step 5—Adjusted Gross Income

Don and Jean claim their **IRA deduction** on **lines 12a–c.** In 1988, Don contributed $750 to his IRA and Jean contributed $650 to hers. Neither is covered by a company-sponsored retirement plan. Jean also contributed an additional $100 to her IRA in January 1989 and asked that it be counted for 1988. They complete IRA Worksheet 1 (as shown here) in their forms instruction package to figure how much of their contributions they can deduct. The entire amount of their contributions to both IRAs is deductible. They enter $750 for Don on line 12a and $750 for Jean on line 12b. The sum of their IRA contributions to both IRAs, $1,500, is entered on line 12c.

Adjusted gross income (line 13). Don and Jean subtract their total IRA deduction on line 12c from their total income on line 11. They enter the result, $34,425, on line 13 and on line 14. This amount is their adjusted gross income. Since it is more than $18,576, they do not qualify for the earned income credit.

IRA Worksheet 1	**(a) Your IRA**	**(b) Your working spouse's IRA**
1. Enter IRA contributions you made for 1988, but **do not** enter more than $2,000 in either column.	750	750
2. Enter wages, salaries, and tips for each person, from Form 1040A, line 7.	19,250	15,155
3. Compare the amounts on lines 1 and 2. Enter the **smaller** of the two amounts on line 3. Enter on Form 1040A, line 12a, the amount from line 3, column (a). Enter on Form 1040A, line 12b, the amount, if any, from line 3, column (b). If married filing a joint return and contributions were made to your nonworking spouse's IRA, go on to line 4.	750	750
	Nonworking spouse's IRA	
4. Compare the amount on line 2, column (a), to $2,250 and enter the **smaller** amount.		
5. Enter the amount from line 3, column (a).		
6. Subtract line 5 from line 4. Enter the result.		
7. Enter IRA contributions made for 1988 for your nonworking spouse, but **not more than** $2,000.		
8. Compare the amounts on lines 2, 6, and 7. Enter **the smallest** of the three amounts on line 8. Also enter this amount on Form 1040A, line 12b.		

Step 6—Taxable Income

Don and Jean figure their **taxable income** on **lines 14–19.**

Standard deduction (lines 15a–c and 16). Lines 15a–c do not apply to either Don or Jean. They find their standard deduction amount of $5,000 (see Chapter 22). They enter this amount on line 16. They subtract line 16 from line 14 and enter the result ($29,425) on line 17.

Then, Don and Jean deduct $1,950 for each exemption they claimed on line 6e. They multiply $1,950 by 4 (the number of exemptions shown on line 6e), subtract the result, $7,800, from line 17, and put the difference, $21,625, on line 19. This amount is their taxable income.

Step 7—Tax, Credits, and Payments

Next, Don and Jean figure their tax liability.

Figure your tax (line 20). Don and Jean must use the Tax Table in the forms instructions package to find their tax. The Smiths' taxable income from line 19 is $21,625. Don and Jean first look for the large print **21,000** in the table. Under this, they look down to income of at least 21,600, but less than 21,650. Their taxable income is between these two amounts. They then find their tax, $3,244, in the column for married filing jointly. They put this amount on line 20 and check the box for "Tax Table."

Credit for child and dependent care expenses (line 21 and Part I of Schedule 1). Don and Jean paid $4,000 of qualified expenses in 1988 for the care of their children while they worked. Their son, Todd, attended an all-day nursery school. The cost for his care at the school was $3,000. Their daughter, Lynn, was cared for by a neighbor before and after school. The neighbor also cared for the children when school was not in session. They paid the neighbor $1,000.

Don and Jean prepare Part I of Schedule 1. Because they had qualified expenses for two children, they enter "2" on line 1. On line 2 they enter the amount of qualified expenses ($4,000) they paid in 1988. On lines 3a and 3b they each enter their earned income. Jean's income was the smaller of the two so they enter her income again on line 3c. Because their child care expenses were less than Jean's earned income, all the expenses can be used to figure the credit. They enter these expenses again on line 4. Then they check the table in Part I to see what percentage of these expenses they can take as a credit. Since their adjusted gross income on line 14 of Form 1040A ($34,425) is over $28,000, they can take 20% of $4,000, or $800, as their credit. They put $800 on line 6. Because their credit is less than their tax, they can use all of it to reduce their federal income tax liability. They enter this credit on line 21 of Form 1040A.

Total tax (line 22). Don and Jean subtract their credit on line 21 from the tax on line 20 and enter the difference, $2,444, on line 22. This amount is their total tax liability.

Total payments (lines 23a–b and 24). Don and Jean then check Box 9 of their Forms W-2 for the amount of Federal income tax withheld from their wages. Don's Form W-2 shows $1,806 tax withheld and Jean's Form W-2 shows $1,248 tax withheld, for a total of $3,054. They enter this amount on lines 23a and 24. They are not entitled to the earned income credit on line 23b.

Step 8—Refund or Amount You Owe

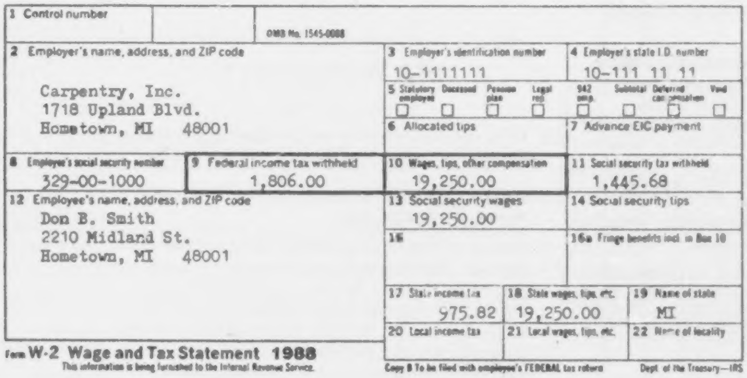
The tax withheld from the Smiths' wages is more than their total tax. They subtract their tax on line 22, $2,444, from their total payments shown on line 24, $3,054, and enter the difference, $610, on line 25. This is the amount that will be refunded to them.

If Don and Jean had not had at least $2,444 withheld for federal income tax, they would have owed tax. They would have entered the difference between their tax (line 22) and their withholding (line 24) on line 26. They would then attach a check or money order for the full amount owed (line 26), payable to "Internal Revenue Service." They would also write "1988 Form 1040A," a daytime telephone number, and Don's social security number (since his name and social security number are listed on the return first) on the front of their check or money order.

Step 9—Sign Your Return

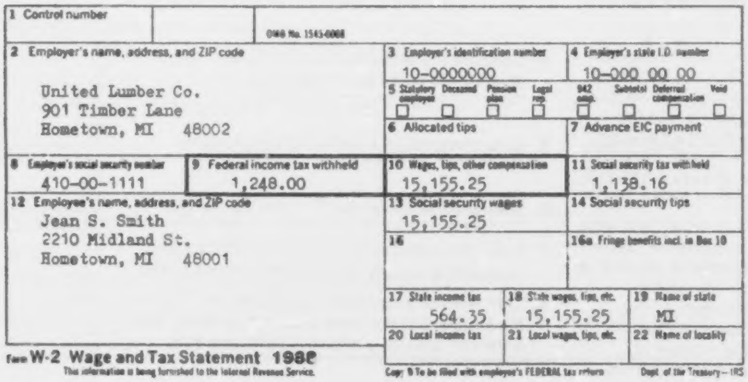
Don and Jean sign and date their return and list their occupations. Then they check their return to make sure it is accurate and complete. They remove the mailing label from the forms package and put it in the address portion on the top of the form. Then they attach Copy B of their Forms W-2 to the location indicated on the front of their return.

They use the envelope that came with their forms package to mail their return to the Service Center. Don and Jean save a copy of their return for their records.



1 Control number
OMB No. 1545-0008
2 Employer's name, address, and ZIP code
Carpentry, Inc.
1718 Upland Blvd.
Hometown, MI 48001
3 Employer's identification number: 10-1111111
4 Employer's state I.D. number: 10-111 11 11
5 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep. ☐ 942 emp. ☐ Subtotal ☐ Deferred compensation ☐ Void ☐
6 Allocated tips
7 Advance EIC payment
8 Employee's social security number: 329-00-1000
9 Federal income tax withheld: 1,806.00
10 Wages, tips, other compensation: 19,250.00
11 Social security tax withheld: 1,445.68
12 Employee's name, address, and ZIP code
Don B. Smith
2210 Midland St.
Hometown, MI 48001
13 Social security wages: 19,250.00
14 Social security tips
16
16a Fringe benefits incl. in Box 10
17 State income tax: 975.82
18 State wages, tips, etc.: 19,250.00
19 Name of state: MI
20 Local income tax
21 Local wages, tips, etc.
22 Name of locality

Form **W-2 Wage and Tax Statement 1988**
This information is being furnished to the Internal Revenue Service.
Copy B To be filed with employee's FEDERAL tax return
Dept. of the Treasury—IRS



1 Control number
OMB No. 1545-0008
2 Employer's name, address, and ZIP code
United Lumber Co.
901 Timber Lane
Hometown, MI 48002
3 Employer's identification number: 10-0000000
4 Employer's state I.D. number: 10-000 00 00
5 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep. ☐ 942 emp. ☐ Subtotal ☐ Deferred compensation ☐ Void ☐
6 Allocated tips
7 Advance EIC payment
8 Employee's social security number: 410-00-1111
9 Federal income tax withheld: 1,248.00
10 Wages, tips, other compensation: 15,155.25
11 Social security tax withheld: 1,138.16
12 Employee's name, address, and ZIP code
Jean S. Smith
2210 Midland St.
Hometown, MI 48001
13 Social security wages: 15,155.25
14 Social security tips
16
16a Fringe benefits incl. in Box 10
17 State income tax: 564.35
18 State wages, tips, etc.: 15,155.25
19 Name of state: MI
20 Local income tax
21 Local wages, tips, etc.
22 Name of locality

Form **W-2 Wage and Tax Statement 1988**
This information is being furnished to the Internal Revenue Service.
Copy B To be filed with employee's FEDERAL tax return
Dept. of the Treasury—IRS

Filled-in Form 1040A

If you need more information, turn to page shown in circle.

Form
1040A

Department of the Treasury – Internal Revenue Service
U.S. Individual Income Tax Return **1988**

OMB No. 1545-0085

Step 1
Label
Use IRS label. Otherwise, please print or type

LABEL HERE

Your fir
DS 329-00-1000 410-00-1111 DO 18 2
Presen DON B. & JEAN S. SMITH
2210 MIDLAND ST
City, t HOMETOWN, MI 48001
⑫
IRS

⑬
Your social security no.
Spouse's social security no.

For **Privacy Act and Paperwork Reduction Act Notice**, see page 3.

⑬ **Presidential Election Campaign Fund**

Do you want $1 to go to this fund? . . . . ☒ Yes ☐ No
If joint return, does your spouse want $1 to go to this fund? ☒ Yes ☐ No

Note: *Checking "Yes" will not change your tax or reduce your refund.*

Step 2
Check your filing status ⑱
(Check only one)

1 ☐ Single (See if you can use Form 1040EZ.)
2 ☒ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security number above and spouse's full name here. ____________
4 ☐ Head of household (with qualifying person). (See page 15.) If the qualifying person is your child but not your dependent, enter this child's name here. ____________
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶ 19____). (See page 16.)

Step 3
Figure your exemptions ㉑
(See page 16 of instructions.)

6a ☒ **Yourself** If someone (such as your parent) can claim you as a dependent on his or her tax return, do not check box 6a. But be sure to check the box on line 15b on page 2.
6b ☒ **Spouse**

No. of boxes checked on 6a and 6b 2

c **Dependents:**

1. Name (first, initial, and last name)	2. Check if under age 5	3. If age 5 or older, dependent's social security number	4. Relationship	5. No. of months lived in your home in 1988
Lynn A. Smith		410 00 1010	Daughter	12
Todd M. Smith	X		Son	12

If more than 7 dependents, see page 19.

No. of your children on 6c who:
● lived with you 2
● didn't live with you due to divorce or separation (see page 19) ____
No. of **other** dependents listed on 6c ____

Attach Copy B of Form(s) W-2 here.

d If your child didn't live with you but is claimed as your dependent under a pre-1985 agreement, check here . . . . ▶ ☐
㊻ e Total number of exemptions claimed.

Add numbers entered on lines above 4

Step 4
Figure your total income

Attach check or money order here.

㊴ 7	Wages, salaries, tips, etc. This should be shown in Box 10 of your W-2 form(s). (Attach Form(s) W-2.)	7	34,405
㊼ 8a	**Taxable** interest income (see page 22). (If over $400, also complete and attach Schedule 1, Part II.)	8a	410
(53) b	**Tax-exempt** interest income (see page 23). (DO NOT include on line 8a.) 8b 35		
(55) 9	Dividends. (If over $400, also complete and attach Schedule 1, Part III.)	9	100
㊵ 10	Unemployment compensation (insurance) from Form(s) 1099-G.	10	1,010
11	Add lines 7, 8a, 9, and 10. Enter the total. This is your **total income**.	▶ 11	35,925

Step 5
Figure your adjusted gross income

(111) 12a	Your IRA deduction from applicable worksheet. Rules for IRAs begin on page 24. 12a 750		
b	Spouse's IRA deduction from applicable worksheet. Rules for IRAs begin on page 24. 12b 750		
c	Add lines 12a and 12b. Enter the total. These are your **total adjustments.**	12c	1,500
13	Subtract line 12c from line 11. Enter the result. This is your **adjusted gross income**. (If this line is less than $18,576 and a child lived with you, see "Earned Income Credit" (line 23b) on page 34 of instructions.)	▶ 13	34,425

Form **1040A** (1988)

Filled–in Form 1040A

If you need more information, turn to page shown in circle.

1988 Form 1040A

Page 2

Step 6 Figure your standard deduction,		14	Enter the amount from line 13.	14	34,425
	(120)	15a	Check if: ☐ You were 65 or older ☐ Blind ☐ Spouse was 65 or older ☐ Blind } **Enter number of boxes checked** ▶ 15a ☐		
	(120)	b	If someone (such as your parent) can claim you as a dependent, check here . . . ▶ 15b ☐		
	(120)	c	If you are married filing separately and your spouse files Form 1040 and itemizes deductions, see page 28 and check here . . . ▶ 15c ☐		
		16	**Standard deduction.** See pages 28–29 for the amount to enter.	16	5,000
exemption amount, and		17	Subtract line 16 from line 14. Enter the result. (If line 16 is more than line 14, enter -0-.)	17	29,425
		18	Multiply $1,950 by the total number of exemptions claimed on line 6e.	18	7,800
taxable income	(154)	19	Subtract line 18 from line 17. Enter the result. (If line 18 is more than line 17, enter -0-.) This is your **taxable income.**	▶ 19	21,625
			If You Want IRS To Figure Your Tax, See Page 29 of the Instructions.		
Step 7 Figure your tax, credits, and payments (including advance EIC payments)	(159)		**Caution:** If you are under age 14 and have more than $1,000 of investment income, check here . . . ▶ ☐ Also see page 30 to see if you have to use Form 8615 to figure your tax.		
	(154)	20	Find the tax on the amount on line 19. Check if from: ☒ Tax Table (pages 37–42) or ☐ Form 8615	20	3,244
	(163)	21	Credit for child and dependent care expenses. Complete and attach Schedule 1, Part I.	21	800
		22	Subtract line 21 from line 20. Enter the result. (If line 21 is more than line 20, enter -0-.) This is your **total tax**.	▶ 22	2,444
	(154)	23a	Total Federal income tax withheld—from Box 9 of your W-2 form(s). (If any is from Form(s) 1099, check here ▶ ☐ .) 23a 3,054		
	(174)	b	Earned income credit, from the worksheet on page 35 of the instructions. Also see page 34. 23b		
		24	Add lines 23a and 23b. Enter the total. These are your **total payments**.	▶ 24	3,054
Step 8 Figure your refund or amount you owe	⑮	25	If line 24 is more than line 22, subtract line 22 from line 24. Enter the result. This is the **amount of your refund.**	25	610
	⑯	26	If line 22 is more than line 24, subtract line 24 from line 22. Enter the result. This is the **amount you owe.** Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number, daytime phone number, and "1988 Form 1040A" on it.	26	

Step 9 Sign your return ⑬

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

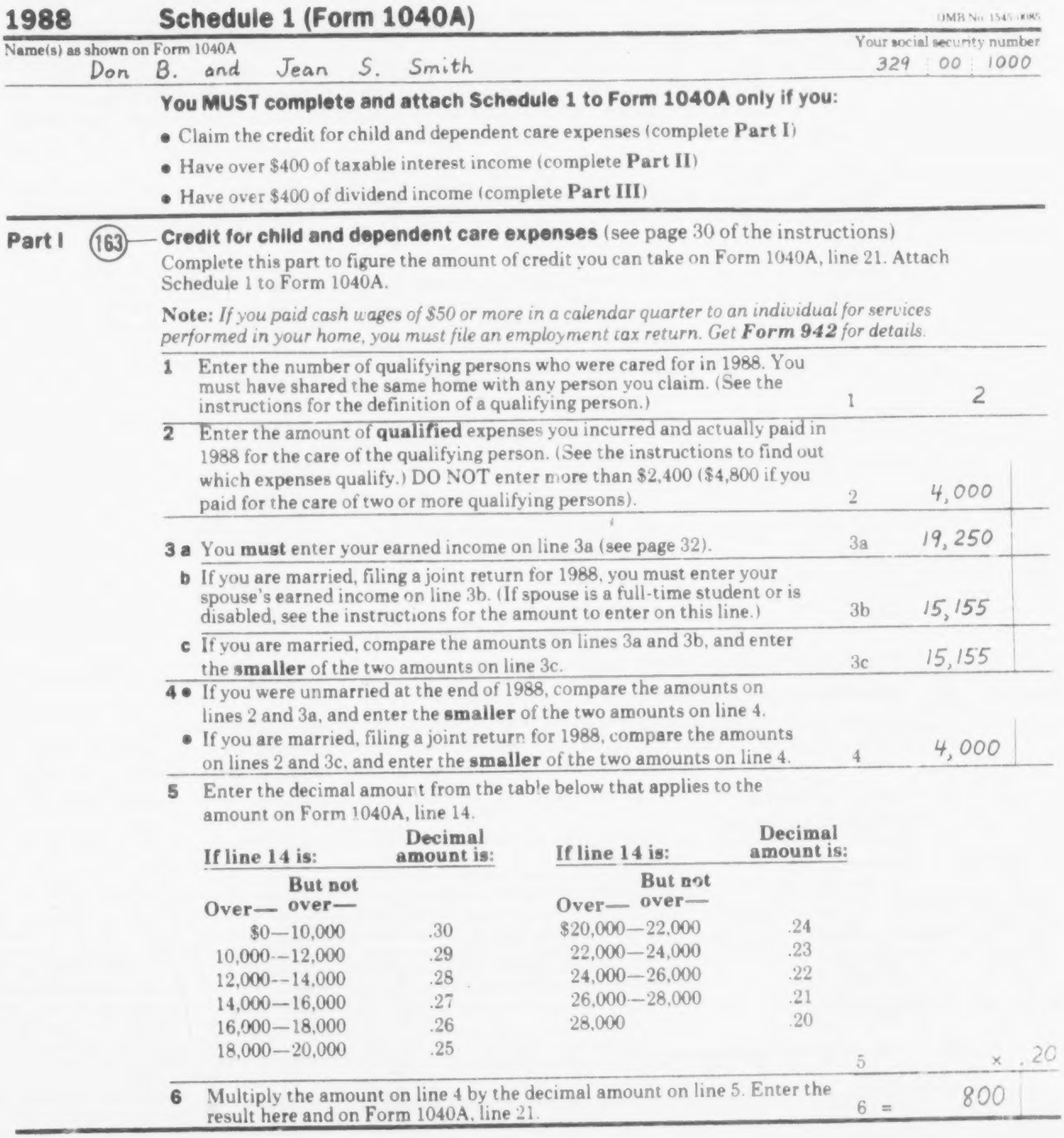
Your signature	Date	Your occupation
x Don B. Smith	2-10-89	Carpenter
Spouse's signature (if joint return, both must sign)	Date	Spouse's occupation
x Jean S. Smith	2-10-89	Secretary

Paid preparer's use only

Preparer's signature x	Date	Preparer's social security no.
Firm's name (or yours if self-employed)		Employer identification no.
Address and ZIP code		Check if self-employed ☐

Filled–in Schedule 1

If you need more information, turn to page shown in circle.



1988 **Schedule 1 (Form 1040A)** OMB No. 1545-0085

Name(s) as shown on Form 1040A
Don B. and Jean S. Smith

Your social security number
329 00 1000

You MUST complete and attach Schedule 1 to Form 1040A only if you:

- Claim the credit for child and dependent care expenses (complete **Part I**)
- Have over $400 of taxable interest income (complete **Part II**)
- Have over $400 of dividend income (complete **Part III**)

Part I ⑯③ — **Credit for child and dependent care expenses** (see page 30 of the instructions)
Complete this part to figure the amount of credit you can take on Form 1040A, line 21. Attach Schedule 1 to Form 1040A.

Note: *If you paid cash wages of $50 or more in a calendar quarter to an individual for services performed in your home, you must file an employment tax return. Get* **Form 942** *for details.*

1	Enter the number of qualifying persons who were cared for in 1988. You must have shared the same home with any person you claim. (See the instructions for the definition of a qualifying person.)	1	2
2	Enter the amount of **qualified** expenses you incurred and actually paid in 1988 for the care of the qualifying person. (See the instructions to find out which expenses qualify.) DO NOT enter more than $2,400 ($4,800 if you paid for the care of two or more qualifying persons).	2	4,000
3 a	You **must** enter your earned income on line 3a (see page 32).	3a	19,250
b	If you are married, filing a joint return for 1988, you must enter your spouse's earned income on line 3b. (If spouse is a full-time student or is disabled, see the instructions for the amount to enter on this line.)	3b	15,155
c	If you are married, compare the amounts on lines 3a and 3b, and enter the **smaller** of the two amounts on line 3c.	3c	15,155
4	• If you were unmarried at the end of 1988, compare the amounts on lines 2 and 3a, and enter the **smaller** of the two amounts on line 4. • If you are married, filing a joint return for 1988, compare the amounts on lines 2 and 3c, and enter the **smaller** of the two amounts on line 4.	4	4,000
5	Enter the decimal amount from the table below that applies to the amount on Form 1040A, line 14.	5	× .20

If line 14 is: Over—	But not over—	**Decimal amount is:**	**If line 14 is:** Over—	But not over—	**Decimal amount is:**
$0	10,000	.30	$20,000	22,000	.24
10,000	12,000	.29	22,000	24,000	.23
12,000	14,000	.28	24,000	26,000	.22
14,000	16,000	.27	26,000	28,000	.21
16,000	18,000	.26	28,000		.20
18,000	20,000	.25			

6	Multiply the amount on line 4 by the decimal amount on line 5. Enter the result here and on Form 1040A, line 21.	6 =	800

Filled-in Schedule 1

If you need more information, turn to page shown in circle.

1988 Schedule 1 (Form 1040A)

OMB No. 1545-0085

Name(s) as shown on Form 1040A. (Do not complete if shown on other side.)

Your social security number

Part II ㊼ **Interest income** (see page 22 of the instructions)

Complete this part and attach Schedule 1 to Form 1040A if you received over $400 in taxable interest. Even if you are not required to complete this part, you must report all interest on Form 1040A.

Note: *If you received a Form 1099-INT or Form 1099-OID from a brokerage firm, enter the firm's name and the total interest shown on that form.*

1 List name of payer	Amount	
First National Bank of Hometown	$ 410	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	

2 Add amounts on line 1. Enter the total here and on Form 1040A, line 8a. 2 410

Part III ㊺ **Dividend income** (see page 23 of the instructions)

Complete this part and attach Schedule 1 to Form 1040A if you received over $400 in dividends. Even if you are not required to complete this part, you must report all taxable dividends on Form 1040A.

Note: *If you received a Form 1099-DIV from a brokerage firm, enter the firm's name and the total dividends shown on that form.*

1 List name of payer	Amount	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	
	$	

38. Form 1040

Frank and Evelyn Jones are a married couple with two children. The sample tax return in this chapter is based on their situation. It shows the proper reporting of items on the tax forms. Frank works full time as an electrician. He is also a partner in the Jones Brothers Partnership. Evelyn, a retired state government employee, is co-owner of a travel agency. Frank and Evelyn own some stocks, bonds, and rental property. In 1988, they sold their home and moved to a new home in a nearby city.

Frank and Evelyn were sent a Form 1040 tax package for 1988. The forms they received were based on the return and schedules they filed last year. They use the order blank in their Form 1040 tax package to order any other forms they need. They correct the address label that came with their forms package to show their change of address. They do not put the label on their return until they have completed and checked the return to make sure it is accurate.

Presidential Election Campaign Fund. Frank and Evelyn each want $1 of their taxes to go to the Presidential Election Campaign Fund. They check both "Yes" boxes. Checking "Yes" will not increase their tax or reduce their refund.

Personal Information

Frank and Evelyn show their filing status and personal exemptions on lines 1–6e.

Filing status (lines 1–5). Because Frank and Evelyn decide to file a joint return, they check the filing status box on line 2, *Married filing joint return.*

Exemptions (lines 6a–6e). Frank and Evelyn show the exemption for Frank on line 6a and for Evelyn on line 6b. They enter "2" on the line to the right of lines 6a and b.

Their daughter Marie, who is 18, earned $2,100 last year. Frank and Evelyn provided more than half her support. They claim Marie as a dependent on line 6c. The gross income test does not apply because she is under 19 and the other dependency tests were met. (See Chapter 3.) Their son James, 22, goes to college full time. During the summer, James earned $2,200, which he spent for his support. The gross income test does not apply because he is a full-time student. Frank and Evelyn provided more than $2,200 toward their son's support and the other dependency tests were met. On line 6c of the return, they claim James as a dependent. Frank and Evelyn write the information asked about Marie and James on line 6c, columns (1), (3), (4), and (5). They do not check column (2) because neither Marie nor James is under age 5. They enter "2" on the first line to the right of line 6c because both Marie and James lived at home.

Grace Smith, Evelyn's mother, lives with Frank and Evelyn and their two children. Grace gets a pension of $2,100 a year and social security of $1,800 a year. She spent this money for clothing and other personal things. Only $1,500 of her pension is gross income for her. The rest of the pension is not taxable because it is a return of cost.

Frank and Evelyn paid a total of $5,000 for food for the family. They also paid Grace's medical and drug expenses of $500. The fair rental value of Grace's share of the house is $2,600 a year. Grace's total support is:

Expenses paid by Grace	$3,900
Expenses paid by Frank and Evelyn:	
Medical	500
Food—Grace's share (⅕ of $5,000)	1,000
Lodging—Grace's share (⅕ of $13,000)	2,600
Total support	$8,000

Because the support Frank and Evelyn provided is more than half of Grace's total support and Grace had less than $1,950 gross income, they may claim her as a dependent. They write the information asked about Grace on line 6c of their return.

Frank Jones and his two brothers provided $3,500 for the total support of their sister, Clara Jones. Frank provided 35%, one brother provided 35%, and the other brother provided the remaining 30%. Any one of them may claim the exemption for Clara if a written statement from each of the others is attached to the income tax return of the brother claiming the exemption. The brothers agree to let Frank claim Clara as his dependent. They each give Frank a signed Form 2120, *Multiple Support Declaration,* for Frank to attach to his return. (Forms 2120 are not shown.) Frank and Evelyn write the information asked about Clara on line 6c. They enter "2" on the fourth line to the right of line 6c for Grace and Clara.

They then enter "6" in the box to the right of line 6e to show the total exemptions they claim. They also enter $11,700 ($1,950 x 6) on line 36.

Income

Frank and Evelyn report the kinds of income they received for the year on lines 7–22.

Wages (line 7). Frank's Form W-2, *Wage and Tax Statement,* shows he earned $20,940. Frank and Evelyn enter $20,940 on line 7.

Interest income (lines 8a and 8b and Part I of Schedule B). Frank and Evelyn have two savings accounts and one tax-exempt municipal bond. The Forms 1099–INT that they received show that they had interest income of $330 from National Bank and $100 from First Savings and Loan. Because their total taxable interest income is more than $400, they must report it on Schedule B. In addition, they received $500 interest from the municipal bond. Since they did not receive a Form 1099–INT for this tax-exempt interest, they do not report it on Schedule B. Frank and Evelyn did not receive any interest from a seller-financed mortgage, so they leave line 1 blank. On line 2 they enter the names of the financial institutions and the interest received from each. They enter the net amount of $430 on line 3, Schedule B, and on line 8a, Form 1040. They show the $500 tax-exempt interest on line 8b, Form 1040. The tax-exempt interest will not be added to their gross income on line 23.

Dividends (line 9 and Part II of Schedule B). During 1988 Frank and Evelyn received or had credited to their accounts the following dividends and other corporate distributions:

Forms 1099–DIV

Acme Publishing Company	$210	
Zepco, Inc.		
Total	$310	
Nontaxable (return of capital) (basis in stock, $5,000)		$10
Equity Money Market Fund	$ 50	
Tiger Mutual Fund		
Total	$ 60	
Capital gain distribution		$60
Equity Brokers	$ 40	

Schedule K–1 (Form 1065)

Frank's share of dividends on stock owned by his partnership	$80

Reporting dividends and other distributions. Frank and Evelyn received more than $400 in dividends, so they must report them on Schedule B.

They list all payers and the total amount received from each payer on line 4, Part II of Schedule B (Form 1040). This includes capital gain distributions and nontaxable distributions. They show the total on line 5. Frank and Evelyn put their capital gain distributions of $60 from the Tiger Mutual Fund on line 6. They also enter this amount on line 13, Part II of Schedule D because they must report other transactions they had during the year on Schedule D. The return of capital distribution from Zepco, Inc., $10, is entered on line 7. They reduce their basis in the stock by this amount.

Frank and Evelyn add the amounts on lines 6 and 7 and enter the total, $70, on line 8, Part II of Schedule B. They subtract this amount from the $750 on line 5 and enter the result, $680, on line 9, Part II of Schedule B, and on line 9, Form 1040.

Foreign accounts and foreign trusts (Part III of Schedule B). Evelyn has a foreign checking account that she uses for her travel agency. Because she had less than $10,000 in the account during 1988, she answers *No* to the question on line 10 in Part III of Schedule B. Neither Frank nor Evelyn was a grantor of, or transferor to, a foreign trust, so they answer *No* to the question on line 11 in Part III of Schedule B.

State and local income tax refunds (line 10). Frank and Evelyn received a state tax refund of $110 in 1988. This amount is shown on the Form 1099–G, *Statement for Recipients of Certain Government Payments,* sent to them by their state. They must report the refund as income on line 10 because they deducted the total state tax paid as an itemized deduction on their 1987 return and the amount paid resulted in a tax benefit in 1987.

Capital gain or loss (line 13 and Schedule D). On line 13, Frank and Evelyn show their income from the sale or exchange of capital assets from Schedule D.

Frank and Evelyn received Forms 1099–B, *Statement for Recipients of Proceeds From Brokers and Barter Exchange Transactions,* from their broker reporting their stock sales. On line 1, Schedule D, they enter $7,400, the total sales of stocks reported by their broker on Forms 1099–B.

In Part I of Schedule D they show their short-term capital gains and losses from assets they held one year or less (6 months or less if acquired before 1/1/88). This year they had a short-term loss of $300 on the sale of stock they bought in 1987 and held for 5 months, and a short-term gain of $100 on the sale of stock they bought in 1988 and held for 8 months. Frank lent $200 in 1984 to a former co-worker. The debt became worthless in September 1988. Because it is a nonbusiness bad debt, they report it as a short-term capital loss in Part I, line 2c of Schedule D. They do not include the proceeds from the sale of their house on line 2c or 9c because they have reported the sale on Form 2119. Frank and Evelyn also had a short-term capital loss carryover of $500 from the previous year. They show this on line 6. They add lines 2a through 6 in column (f) and enter the total short-term loss ($1,000) on line 7, column (f). They add lines 2a through 6 in column (g) and enter the total ($100) on line 7, column (g). Frank and Evelyn combine the amounts in columns (f) and (g) line 7 and enter the total loss ($900) on line 8.

They use Part II of Schedule D to show long-term capital gains and losses from assets held more than one year (more than 6 months if acquired before 1/1/88). In this part Frank and Evelyn show a $3,000 gain from the sale of stock on line 9a and a $560 loss from a worthless bond on line 9c. Even though the bond was not held for more than one year, the loss is a long-term loss because the bond was bought before 1988 and held for more than 6 months. They also enter $300, Frank's share of long-term capital gain from his partnership on line 12, and $60 from capital gain distributions on line 13. They add lines 9a through 15 in column (f) and enter the total ($560) on line 16, column (f). They add lines 9a through 15 in column (g) and enter the total ($3,360) on line 16, column (g). They combine columns (f) and (g), line 16, and enter the net amount ($2,800) on line 17.

In Part III of Schedule D they must summarize Parts I and II. They combine their net short-term capital loss, $900, with their net long-term capital gain, $2,800, and enter the result, $1,900, on line 18 , Schedule D, and on line 13, Form 1040.

Pensions (lines 17a and 17b). Evelyn had retired on January 31, 1986, with a monthly pension of $400. Her pension cost was $11,900. During the first 36 months of her retirement, she will get $14,400, which is more than her total cost. In 1986 she received $4,400 ($400 x 11), which was tax free. In 1987 she received $4,800, which was also tax free. However, in 1988 she must show $2,100 as taxable income. She figures this on the worksheet in the instructions to line 17b of Form 1040 in the following way:

1) a) Enter your cost	$ 11,900
b) Cost recovered in prior years	9,200
c) Subtract line 1b from line 1a	$ 2,700
2) Amount received this year. Also enter this amount on Form 1040, line 17a	$ 4,800
3) Enter amount from line 1c above	2,700
4) **Taxable amount.** Subtract line 3 from line 2. Enter the result (but not less than zero). Also enter this amount on Form 1040, line 17b	$ 2,100

Frank and Evelyn show the total of Evelyn's partly taxable pension on line 17a, Form 1040. They show the taxable amount, $2,100, on line 17b. In 1989 and all the following years, the entire amount Evelyn gets will be taxable. If Evelyn had retired after July 1, 1986, part of each pension payment would have been nontaxable and part taxable. She would not have been able to use the three-year rule.

Rental, royalty, partnership, and trust income (line 18 and Schedule E). Frank and Evelyn show their total income from these sources on Schedule E and on line 18, Form 1040.

Rental and royalty income (Part I of Schedule E). Frank received $8,400 rental income on a store building he owns. Frank manages the rental activity of the store building, so he checks the "YES" box on line 3, Part I, Schedule E. He enters the income on line 4, column A of Schedule E. He lists expenses such as real estate taxes, interest, insurance, and general repairs on the appropriate lines in column A. On line 19 he shows transportation expenses at 24 cents per mile. Total expenses of $5,420 are entered on line 20. He shows depreciation of $1,000 on line 21.

Frank's records show that he purchased the rental property in 1975. His basis is $40,000 and he is using the straight-line method of depreciation with a 40-year life. The depreciation for 1988 is $1,000. Because Frank's store building was placed in service before 1981, he does not have to complete Form 4562, *Depreciation and Amortization,* or show his depreciation computation.

Frank also had rental income of $720 from a piece of land he owns. He enters this rental income on line 4, column B of Schedule E. His only expense is property tax of $100, which he paid in 1988. They add the rental and royalty income on line 23 and enter the result, $2,600, on lines 25, 27, and 29 on Schedule E.

Partnership and trust income (Parts II and III of Schedule E). Frank is an active partner in the Jones Brothers Partnership. His share of income, credits, and deductions, shown on the Schedule K-1 (Form 1065) given to him by the partnership, is:

Ordinary nonpassive income	$4,600
Long-term capital gain from the sale of stock	300
Dividend income	80
Charitable contributions	50
Net self-employment income	4,600

Evelyn is an active partner in the Gateway Travel Agency. Her share of income, shown on Schedule K-1 (Form 1065), is:

Ordinary nonpassive income	$1,900
Net self-employment income	1,900

Frank and Evelyn are at risk for the amounts invested in each of their partnerships. They check the "All is at risk" box in column (e) Part II, Schedule E. They do not have to complete Form 6198, *Computation of Deductible Loss From an Activity Described in Section 465(c).*

Frank and Evelyn report the ordinary nonpassive income from both of the partnerships in column (k) Part II, of Schedule E (Form 1040). They enter the total partnership income of $6,500 on lines 31 and 33 of Schedule E. They report the long-term capital gain on line 12, column (g) of Schedule D (Form 1040); the contributions on Schedule A (Form 1040); and the net self-employment income on line 2, Section A of Schedule SE (Form 1040). Because Frank and Evelyn each had self-employment income, they each must complete a separate Schedule SE. See *Other Taxes,* later.

Frank had taxable income of $1,400 from a trust set up by his grandfather. They show the trust's name and employer identification number in columns (a) and (b) of Part III of Schedule E. They report the income in column (d) of the *Passive Activities* section of Part III. They also enter the total trust income of $1,400 on lines 34a, 35, and 37 in Part III.

In Part VI of Schedule E they combine the amounts on lines 29, 33, and 37. They enter the total, $10,500, on line 42, Schedule E, and on line 18, Form 1040.

Other income (line 22). Frank won a $50 prize in a photography contest. Frank and Evelyn show this income on line 22, Form 1040.

Frank and Evelyn add the amounts on lines 7 through 22 to figure their total income, $36,710. They enter this amount on line 23.

Sale of Your Home (Form 2119)

Frank and Evelyn do not have a taxable gain on the sale of their home. However, they must report the sale on Form 2119, *Sale of Your Home.* Some of the expenses of the sale of the old home and the purchase of the new home qualify as a moving expense deduction.

Frank and Evelyn bought and moved into their new home May 1, 1988, and sold their old home May 2, 1988. They are over 55 and meet all of the tests for the once-in-a-lifetime exclusion of up to $125,000 of the gain on the sale. They choose to take the exclusion.

Their records are as follows:

Old home		
Original basis (purchased 1955)		$ 18,000
Improvements		7,000
Adjusted basis		$ 25,000
Fixing-up expenses for sale		$ 1,000
Settlement charges at closing		
Selling price		$ 160,000
Realtor's commission	$ 8,000	
Balance of mortgage	4,500	
Penalty for prepayment of mortgage	50	
Mortgage interest (4/1/88–5/2/88)	20	
Points—charged to seller (loan origination fee, 1%)	1,000	
Real estate taxes (1/1/88–5/2/88)	630	14,200
Net received		$ 145,800
New home		
Purchase price		$ 90,000
Settlement charges at closing		
Title search, attorney fees, and other settlement fees	$ 1,300	
Points charged to buyer (1%)	400	
Mortgage assumed	(40,000)	
Down payment	(5,000)	
Real estate taxes (1/1/88–5/1/88—credit from seller)	(300)	(43,600)
Balance due		$ 46,400

Frank and Evelyn first complete Form 3903, *Moving Expenses,* because they must decide which of these expenses qualify for their moving expense deduction. (See *Moving expenses,* later.) From the sale of their old home, they can claim as moving expenses the realtor's commission of $8,000 and the points that they were required to pay, for a total of $9,000. Of that amount, however, they cannot deduct more than $3,000 as a moving expense; the rest can be used to reduce the gain on the sale of the home. The penalty for prepayment of the mortgage is deductible as interest on Schedule A (Form 1040). From the purchase of their new home, only the settlement fees of $1,300 qualify as a moving expense. The points paid are deductible as an interest expense on Schedule A.

Because of the $3,000 limit on certain moving expenses that total $10,960 (line 21 of Form 3903), Frank and Evelyn must decide what part of the $10,960 should be deducted as moving expenses under the $3,000 limit. They decide to take the total pre-move expenses, $660 (line 19 of Form 3903), which are not deductible on any other schedule or form, and deduct it as part of the $3,000 moving expense limit. They use $2,340 of the selling expenses of their old home as a moving expense to make up the remainder of the $3,000 limit.

Frank and Evelyn figure the amount realized, the gain realized, and the adjusted sales price on the sale of their old home as follows:

Selling price	$160,000
Less: Selling expenses ($9,000 − $2,340 deducted as moving expenses)	6,660
Amount realized	$153,340
Less: Adjusted basis	25,000
Gain realized	$126,340

They figure the adjusted basis of their new home as follows:

Gain realized—old home	$128,340
Less: Exclusion allowed	125,000
Gain postponed	$ 3,340
Purchase price—new home	$ 90,000
Plus: Settlement fees	1,300
Total cost	$ 91,300
Less: Gain postponed—old home	3,340
Adjusted basis — new home	$ 87,960

Frank and Evelyn put this information on the appropriate lines of Form 2119. They do not sign Form 2119 since they are attaching it to their tax return.

Adjustments to Income

Frank and Evelyn report their adjustments to income on lines 23–29.

IRA deduction (lines 25a and b). Frank and Evelyn both received earned income, so each of them made contributions to an individual retirement arrangement (IRA). Frank's earned income is $25,540 ($20,940 wages plus $4,600 self-employment income). Evelyn's only earned income is her $1,900 self-employment income.

Frank contributed $2,000 to his IRA in 1988. Evelyn contributed $900 to her IRA for 1988 in February 1989. Because neither Frank nor Evelyn was covered by an employer retirement plan during 1988, they may deduct their total contributions. They show Frank's $2,000 contribution on line 25a and Evelyn's $900 contribution on line 25b of Form 1040. Frank and Evelyn use the IRA worksheet 1 from page 14 of Form 1040 instructions to figure their IRA deductions. The worksheets are not filed with the return. Only Frank's worksheet is shown here.

Note: *If you were married and both spouses worked and both had IRAs, figure each spouse's deduction separately.*

IRA Worksheet 1 (Keep for your records)

1. Enter IRA contributions you made for 1988, but **do not** enter more than $2,000 2,000
2. Enter your wages and other earned income from Form 1040, minus any deduction you claim on Form 1040, line 27 (Do not include your spouse's income and do not reduce your wages by losses from self-employment.) 25,540
3. Compare the amounts on lines 1 and 2 and enter the **smaller** of the two amounts on line 3. Enter on Form 1040, line 25a or 25b, whichever applies, the amount on line 3 you choose to deduct. If contributions were made to your nonworking spouse's IRA, go on to line 4 2,000

Nonworking Spouse's IRA

Complete lines 4 through 8 ONLY if contributions were made to an IRA for your nonworking spouse (as defined on this page).

4. Compare the amount on line 2 to $2,250. Enter the **smaller** of the two amounts ________
5. Enter the amount from line 3 ________
6. Subtract line 5 from line 4 ________
7. Enter IRA contributions made for 1988 for your nonworking spouse, but **do not** enter more than $2,000 ________
8. Compare the amounts on lines 2, 6, and 7 and enter the **smallest** of the three amounts on line 8. Enter on Form 1040, line 25b, the amount on line 8 you choose to deduct ________

Adjusted gross income (line 31). Frank and Evelyn add the amounts from lines 25a and 25b, and enter $2,900 on line 30. They then subtract line 30 from line 23. This amount, $33,810, is their adjusted gross income. They enter it on lines 31 and 32. This is the amount they use to figure the limit on their medical deduction and the limit on their miscellaneous deductions.

Standard Deduction

Frank and Evelyn must decide whether to take the standard deduction or itemize their actual deductions. Because Frank was 65 in November 1988, he checks the first block on line 33a and enters "1" in the box at the end of line 33a. Their standard deduction is $5,600. They will use this amount to compare to their itemized deductions when they complete Schedule A.

Itemized Deductions (Schedule A)

Medical and dental expenses (lines 1a–4, Schedule A). Frank and Evelyn paid the following medical expenses:

1) $233 for prescribed medicines and drugs,
2) $300 for prescribed medicines and drugs for Grace Smith (Evelyn's dependent mother),
3) $350 for prescribed medicines and drugs for Clara Jones (Frank's dependent sister),
4) $844 for medical insurance,
5) $237 for hospital and doctor bills not reimbursed by insurance,
6) $200 for doctors for Grace Smith,
7) $350 for doctors for Clara Jones, and
8) $50 for transportation (400 miles at 9 cents a mile plus parking fees).

Frank and Evelyn enter the total $2,514 for prescription medicines and drugs, doctors, hospitals, and medical insurance on line 1a. On line 1b they enter $50, and list the transportation expense. They enter $2,564, the total of their medical expenses, on line 2. On line 3, they enter $2,536, which is 7.5% of their adjusted gross income ($33,810) as shown on line 32 of Form 1040. They subtract line 3 from line 2 and enter the result, $28, on line 4.

Taxes you paid (lines 5–8, Schedule A). Frank and Evelyn next itemize the deductible taxes they paid during the year.

Frank had $1,301 state income tax withheld from his salary during 1988. They write $1,301 on line 5.

Frank and Evelyn's tax year for real estate taxes is the calendar year with payment due August 1. Their share of the tax on their old home, sold on May 2, was $630. Frank and Evelyn are considered to have paid their share of the real estate taxes on their old home even though they did not actually pay them to the tax authority.

They may claim only their share of taxes paid on their new home even though they paid the entire amount of $910. Frank and Evelyn must subtract from this the taxes paid by the seller when they purchased the home, $300. Their share of the taxes on the new home is $610.

Frank and Evelyn also paid $200 real estate taxes on a lakeside cottage they own.

Frank and Evelyn's real estate tax deduction is $1,440 ($630 + $610 + $200). They write this amount on line 6, Schedule A.

Frank and Evelyn show their total taxes paid, $2,741, on line 8, Schedule A.

Interest you paid (lines 9a–13, Schedule A). Frank and Evelyn made mortgage interest payments on both their old and new homes in 1988. From January to April they paid $140 interest on the old mortgage. The settlement sheet for the sale of the old home showed $50 penalty for prepayment of mortgage and $20 interest for the period of April 1 through May 2. This did not include the date of sale. The sum of these amounts, $210, is their mortgage interest deduction for their old mortgage. They received a Form 1098, *Mortgage Interest Statement*, for their new home from their mortgage holder showing they paid $2,300 interest in 1988. They write the total amount, $2,510, on line 9a because these amounts were paid to financial institutions. Frank and Evelyn paid more mortgage interest than shown on Form 1098. After determining that the additional interest is deductible, they attach a statement to their return explaining the difference and write "see attached" next to line 9a. (The statement is not shown.) Their Form 1098 does not include the $400 deductible points they paid at closing. They report this amount on line 10. They also list $130 interest expense paid on their credit card and revolving charge accounts on line 12a. The deductible amount of $130 personal interest is $52 ($130 x .40). They enter $52 on line 12b. The total interest they may deduct in 1988 is $2,962. They show this amount on line 13, Schedule A.

Gifts to charity (lines 14–17, Schedule A). Frank and Evelyn made all their charitable contributions in cash. They have receipts for all their contributions. They write the total, $912, on line 14. They also write this amount on line 17. The total includes a $50 contribution from the Jones Brothers Partnership. This is Frank's share of the partnership's contribution as shown on his Schedule K–1 (Form 1065).

Casualty and theft losses (line 18, Schedule A). Frank and Evelyn did not have any casualty or theft losses, so they do not make an entry on line 18.

Moving expenses (line 19, Schedule A and Form 3903). Frank was transferred by his employer to a new job in another city. Frank and Evelyn decided to sell their home and move closer to Frank's new job. They keep their partnership interests at the old location because they can still carry out their duties by mail and telephone from their new home and would not have to commute. Frank's employer did not reimburse him for any of the moving expenses. They bought a condominium apartment. Some of the expenses of the sale of their old home and the purchase of their new home can be deducted as moving expenses. These were shown earlier under *Sale of Your Home.*

Frank and Evelyn make sure that the move meets the distance and time tests explained in Chapter 28. The distance from their old home to Frank's new job is 91 miles farther than the distance from their old home to Frank's old job. Therefore, they meet the 35–mile distance test. Also, Frank expects to meet the 39–week full-time work test. Their records show the following expenses for the move:

Paid to van company for moving furniture and household goods	$ 530
Car mileage to drive from old to new home—100 miles at 9¢ a mile	9
Motel rcom rent for one night on the day of arrival	61
Meals on the day of arrival	50
Pre-move expenses looking for new home (mileage, motels)	500
Meals	200
Expenses of selling old home	9,000
Expenses of buying new home	1,300

They figure the moving expense deduction on Form 3903, *Moving Expenses,* which they attach to their return.

Transportation of household goods (Section A, Part I, of Form 3903). They show the total cost to move furniture and other household goods, $530, on line 4, Form 3903.

Expenses of moving from old to new home (Section B, Part I, of Form 3903). The amount they show on line 5 is $70. This is the total of the car mileage and the motel room rent. They show $50 spent for meals on the day of arrival on line 6. They enter $40 ($50 x .80) on line 7. They add the amounts on lines 5 and 7 and enter the total, $110, on line 8.

Pre-move househunting expenses (Section C, Part I, of Form 3903). On line 9, Frank and Evelyn show their pre-move mileage and motel expenses of $500. They enter $200 pre-move meal expenses on line 10. They show $160 ($200 x .80) on line 11. Frank and Evelyn add the amounts on lines 9 and 11 and enter the total, $660, on line 12. Since they did not have any temporary living expenses, they enter "0" on line 16.

Qualified real estate expenses (Section E, Part I, Form 3903). They enter the expenses of selling the old home, $9,000, on line 17, and check box 17a. They also enter the expense of buying the new home, $1,300, on line 18, and check box 18a.

Dollar limitations (Part II of Form 3903). Frank and Evelyn add lines 12 and 16 and enter the total, $660, on line 19. The total is less than $1,500, so they enter $660 on line 20. They add lines 17, 18, and 20 and enter the total, $10,960, on line 21. The total is more than the limit, so they enter the limit, $3,000, on line 22. They add lines 4, 8, and 22 and enter the result, $3,640, on line 23 and on line 19, Schedule A.

Job expenses and miscellaneous deductions (lines 20–24, Schedule A). Frank and Evelyn show union dues of $150, safe deposit box rent of $25, and small tools needed for Frank's job costing $75, and enter the total of these deductions, $250, on line 21.

They add lines 20 and 21, and enter the total, $250, on line 22, Schedule A. They enter $676 ($33,810 x .02) on line 23. They subtract line 23 from line 22 and enter the result, "0," on line 24.

Other miscellaneous deductions (line 25). Frank and Evelyn do not have any miscellaneous deductions not subject to 2% AGI limit, so they enter "0" on line 25.

Summary of itemized deductions (line 26, Schedule A). Frank and Evelyn then add lines 4, 8, 13, 17, 18, 19, 24, and 25, and write the total of their itemized deductions, $10,283, on line 26. Since the total of their itemized deductions is larger than their standard deduction ($5,600), they enter $10,283 on line 34 and check the box for itemized deductions.

Tax Computation

Frank and Evelyn are now ready to figure their tax on lines 35–40. They had already entered their *adjusted gross income* on line 32 and their *itemized deductions* on line 34 (see these discussions earlier).

Frank and Evelyn subtract their itemized deductions on line 34 from their adjusted gross income on line 32 and enter $23,527 on line 35. Frank and Evelyn had entered $11,700 on line 36 (see *Exemptions,* under *Personal Information,* earlier), and now subtract this from line 35. The result, $11,827, is their taxable income. They enter it on line 37.

Frank and Evelyn must use the Tax Table to figure their tax because their taxable income is less than $50,000. They read down the income column until they find the line that includes their taxable income of $11,827. Next, they find the column heading that describes their filing status—married filing jointly — and read down the column. The amount shown where the income line and filing status column meet, $1,774, is their tax. They write it on line 38 and check the box marked *Tax Table.* Because Frank and Evelyn do not owe any additional taxes, they also write $1,774 on line 40.

Credits

Because Frank and Evelyn do not have any credits (lines 41–45) they enter zero on line 46 and $1,774 on line 47.

Other Taxes

Frank and Evelyn each have self-employment income over $400 and their total self-employment tax is the only "Other" tax shown on lines 48–53.

Self-employment tax (line 48 and Schedule SE). Frank and Evelyn each figure their self-employment tax on a separate Schedule SE. They can each use the short Schedule SE (Section A).

Evelyn enters her net self-employment income of $1,900 on line 2 of Section A. She enters $1,900 on line 3, also. Since she had no wages subject to social security, she enters "0" on line 5. She subtracts line 5 from line 4, and enters $45,000 on line 6. On line 7 she enters $1,900, the smaller of line 3 and line 6. Evelyn's self-employment tax is $247 ($1,900 x13.02%), which she enters on line 8.

On a separate Schedule SE, Frank enters his net self-employment income, $4,600, on lines 2 and 3 of Section A. Frank had wages of $20,940 subject to social security tax, which he enters on line 5. Frank subtracts the amount on line 5 from the amount on line 4 and enters the difference ($24,060) on line 6. Frank enters $4,600 on line 7, since it is the smaller of line 3 and line 6. Frank's self-employment tax is $599 ($4,600 x13.02%), which he enters on line 8.

They add Frank's self-employment tax and Evelyn's self-employment tax and enter the total, $846, on line 48, Form 1040. They attach both Schedules SE to their Form 1040.

Because they are not liable for any other taxes, they add line 48 to the amount on line 47. This total, $2,620, is Frank and Evelyn's total tax. They enter it on line 53.

Payments

Frank and Evelyn enter $2,200 on line 54. This is the amount of federal income tax withheld from Frank's salary, as shown on his Form W–2. On line 55, they write $500—the amount of estimated tax payments they made during 1988.

Frank and Evelyn enter on line 61, Form 1040, the total of these payments, $2,700.

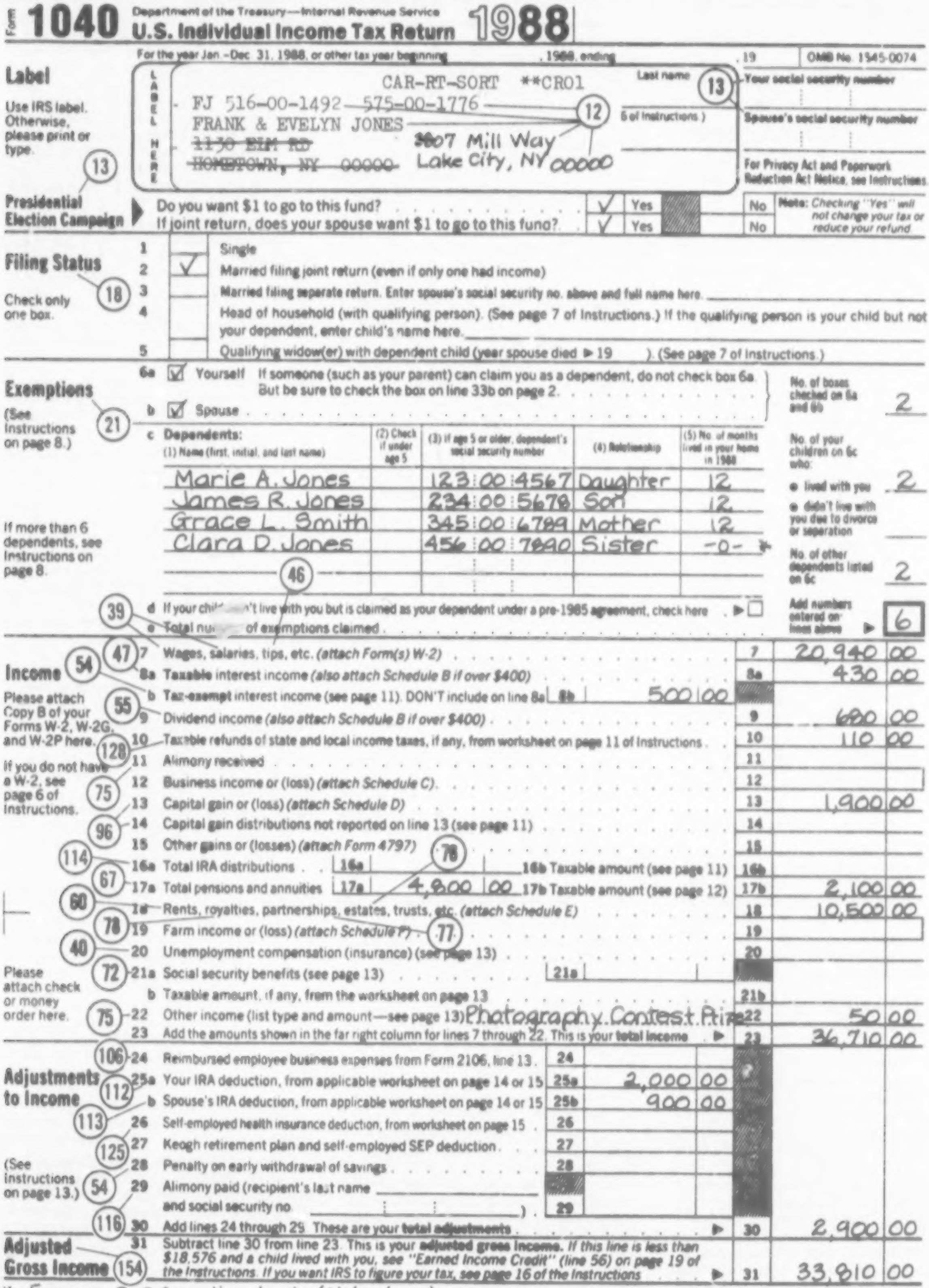
Refund or Amount You Owe

Because line 61 is more than line 53, Frank and Evelyn have overpaid their taxes. They write the amount of the overpayment, $80, on line 62. Because they do not want this amount credited to their 1989 estimated tax, they also enter $80 on line 63. This is the amount of their refund.

They check their return to make sure they have completed all the items and the schedules called for and that the schedules and forms are attached in attachment sequence number order. The attachment sequence number is just below the year in the upper right corner of the schedule or form. They remove the mailing label from the forms package and put it in the address portion on the top of Form 1040. They mark through the old address and put their new address on the label. Frank and Evelyn sign the return and date it, because it is a joint return. Also, Frank and Evelyn enter their occupations in the space provided next to the signature lines. They then use the envelope that came with their forms package to mail the return to the Service Center for their area.

Filled-in Form 1040

If you need more information, turn to the page shown in the circle.



Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **1988**

For the year Jan.–Dec. 31, 1988, or other tax year beginning , 1988, ending , 19 | OMB No. 1545-0074

Label ⑬
Use IRS label. Otherwise, please print or type.

LABEL HERE
CAR-RT-SORT **CR01
FJ 516-00-1492 575-00-1776 ⑫
FRANK & EVELYN JONES
~~1130 ELM RD~~ 3607 Mill Way
~~HOMETOWN, NY 00000~~ Lake City, NY 00000

Last name ⑬ Your social security number
6 of Instructions.) Spouse's social security number

For Privacy Act and Paperwork Reduction Act Notice, see Instructions.

Presidential Election Campaign ▶
Do you want $1 to go to this fund? ✓ Yes ☐ No
If joint return, does your spouse want $1 to go to this fund? ✓ Yes ☐ No
Note: *Checking "Yes" will not change your tax or reduce your refund.*

Filing Status ⑱
Check only one box.
1 ☐ Single
2 ☑ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here. ________
4 ☐ Head of household (with qualifying person). (See page 7 of Instructions.) If the qualifying person is your child but not your dependent, enter child's name here. ________
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 7 of Instructions.)

Exemptions ㉑
(See Instructions on page 8.)
6a ☑ Yourself If someone (such as your parent) can claim you as a dependent, do not check box 6a. But be sure to check the box on line 33b on page 2.
b ☑ Spouse
No. of boxes checked on 6a and 6b: 2

c Dependents: ㊻

(1) Name (first, initial, and last name)	(2) Check if under age 5	(3) If age 5 or older, dependent's social security number	(4) Relationship	(5) No. of months lived in your home in 1988
Marie A. Jones		123 00 4567	Daughter	12
James R. Jones		234 00 5678	Son	12
Grace L. Smith		345 00 6789	Mother	12
Clara D. Jones		456 00 7890	Sister	-0- *

If more than 6 dependents, see Instructions on page 8.

No. of your children on 6c who:
- lived with you: 2
- didn't live with you due to divorce or separation: ____

No. of other dependents listed on 6c: 2

㊴
d If your child didn't live with you but is claimed as your dependent under a pre-1985 agreement, check here ▶ ☐
e Total number of exemptions claimed
Add numbers entered on lines above ▶ 6

Income
Please attach Copy B of your Forms W-2, W-2G, and W-2P here.
If you do not have a W-2, see page 6 of Instructions.
Please attach check or money order here.

㊼	7	Wages, salaries, tips, etc. *(attach Form(s) W-2)*	7	20,940 00
(54)	8a	**Taxable** interest income *(also attach Schedule B if over $400)*	8a	430 00
	b	**Tax-exempt** interest income (see page 11). DON'T include on line 8a 8b 500 00		
(55)	9	Dividend income *(also attach Schedule B if over $400)*	9	690 00
(128)	10	Taxable refunds of state and local income taxes, if any, from worksheet on page 11 of Instructions	10	110 00
	11	Alimony received	11	
(75)	12	Business income or (loss) *(attach Schedule C)*	12	
	13	Capital gain or (loss) *(attach Schedule D)*	13	1,900 00
(96)	14	Capital gain distributions not reported on line 13 (see page 11)	14	
	15	Other gains or (losses) *(attach Form 4797)* (78)	15	
(114)	16a	Total IRA distributions 16a	16b Taxable amount (see page 11) 16b	
(67)	17a	Total pensions and annuities 17a 4,800 00	17b Taxable amount (see page 12) 17b	2,100 00
(60)	18	Rents, royalties, partnerships, estates, trusts, etc. *(attach Schedule E)*	18	10,500 00
(78)	19	Farm income or (loss) *(attach Schedule F)* (77)	19	
(40)	20	Unemployment compensation (insurance) (see page 13)	20	
(72)	21a	Social security benefits (see page 13) 21a		
	b	Taxable amount, if any, from the worksheet on page 13	21b	
(75)	22	Other income (list type and amount—see page 13) Photography Contest Prize	22	50 00
	23	Add the amounts shown in the far right column for lines 7 through 22. This is your **total income** ▶	23	36,710 00

Adjustments to Income
(See Instructions on page 13.)

(106)	24	Reimbursed employee business expenses from Form 2106, line 13	24	
(112)	25a	Your IRA deduction, from applicable worksheet on page 14 or 15	25a	2,000 00
(113)	b	Spouse's IRA deduction, from applicable worksheet on page 14 or 15	25b	900 00
	26	Self-employed health insurance deduction, from worksheet on page 15	26	
(125)	27	Keogh retirement plan and self-employed SEP deduction	27	
	28	Penalty on early withdrawal of savings	28	
(54)	29	Alimony paid (recipient's last name ________ and social security no. ________)	29	
(116)	30	Add lines 24 through 29. These are your **total adjustments** ▶	30	2,900 00

Adjusted Gross Income (154)

	31	Subtract line 30 from line 23. This is your **adjusted gross income.** *If this line is less than $18,576 and a child lived with you, see "Earned Income Credit" (line 56) on page 19 of the Instructions. If you want IRS to figure your tax, see page 16 of the Instructions* ▶	31	33,810 00

* Forms 2120 attached (Not shown)

Filled–in Form 1040

If you need more information, turn to the page shown in the circle.

Form 1040 (1988) Page 2

Tax Computation		32	Amount from line 31 (adjusted gross income)			32	33,810 00
	(120)	33a	Check if: ☑ **You were 65 or older** ☐ Blind; ☐ **Spouse was 65 or older** ☐ Blind. Add the number of boxes checked and enter the total here ▶	33a	1		
		b	If someone (such as your parent) can claim you as a dependent, check here ▶	33b ☐			
		c	If you are married filing a separate return and your spouse itemizes deductions, or you are a dual-status alien, see page 16 and check here ▶	33c ☐			
	(121) (123)	34	Enter the larger of: • Your **standard deduction** (from page 17 of the Instructions), **OR** • Your **itemized deductions** (from Schedule A, line 26). If you itemize, attach Schedule A and check here ▶ ☑			34	10,283 00
		35	Subtract line 34 from line 32. Enter the result here			35	23,527 00
		36	Multiply $1,950 by the total number of exemptions claimed on line 6e			36	11,700 00
	(155)	37	**Taxable income.** Subtract line 36 from line 35. Enter the result (if less than zero, enter zero) **Caution:** If under age 14 and you have more than $1,000 of investment income, check here ▶ ☐ and see page 17 to see if you have to use Form 8615 to figure your tax.			37	11,827 00
		38	Enter tax. Check if from: ☑ Tax Table, ☐ Tax Rate Schedules, or ☐ Form 8615			38	1,774 00
		39	Additional taxes (see page 17). Check if from: ☐ Form 4970 ☐ Form 4972			39	
		40	Add lines 38 and 39. Enter the total ▶			40	1,774 00
Credits (See instructions on page 18.)	(163)	41	Credit for child and dependent care expenses *(attach Form 2441)*	41			
		42	Credit for the elderly or the disabled *(attach Schedule R)*	42			
	(169)	43	Foreign tax credit *(attach Form 1116)*	43			
		44	General business credit. Check if from: ☐ Form 3800 or ☐ Form (specify) ________	44			
		45	Credit for prior year minimum tax *(attach Form 8801)*	45			
	(9)	46	Add lines 41 through 45. Enter the total.			46	-0-
		47	Subtract line 46 from line 40. Enter the result (if less than zero, enter zero) ▶			47	1,774 00
Other Taxes (Including Advance EIC Payments)	(157)	48	Self-employment tax *(attach Schedule SE)*			48	846 00
		49	Alternative minimum tax *(attach Form 6251)*			49	
	(47)	50	Recapture taxes (see page 18). Check if from: ☐ Form 4255 ☐ Form 8611			50	
		51	Social security tax on tip income not reported to employer *(attach Form 4137)*			51	
	(115)	52	Tax on an IRA or a qualified retirement plan *(attach Form 5329)*			52	
		53	Add lines 47 through 52. This is your **total tax** ▶			53	2,620 00
Payments Attach Forms W-2, W-2G, and W-2P to front.	(157)	54	Federal income tax withheld (If any is from Form(s) 1099, check ▶ ☐)	54	2,200 00		
	(35)	55	1988 estimated tax payments and amount applied from 1987 return	55	500 00		
		56	Earned income credit (see page 19)	56			
		57	Amount paid with Form 4868 (extension request)	57			
	(174)	58	Excess social security tax and RRTA tax withheld (see page 20)	58			
		59	Credit for Federal tax on fuels *(attach Form 4136)*	59			
	(176)	60	Regulated investment company credit *(attach Form 2439)*	60			
		61	Add lines 54 through 60. These are your **total payments** ▶			61	2,700 00
Refund or Amount You Owe	(15)	62	If line 61 is larger than line 53, enter amount **OVERPAID** ▶			62	80 00
		63	Amount of line 62 to be **REFUNDED TO YOU** ▶			63	80 00
		64	Amount of line 62 to be applied to your 1989 estimated tax ▶	64			
	(36)	65	If line 53 is larger than line 61, enter **AMOUNT YOU OWE.** Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number, daytime phone number, and "1988 Form 1040" on it Check ▶ ☐ if Form 2210 (2210F) is attached. See page 21. Penalty: $			65	

Please Sign Here (13)

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

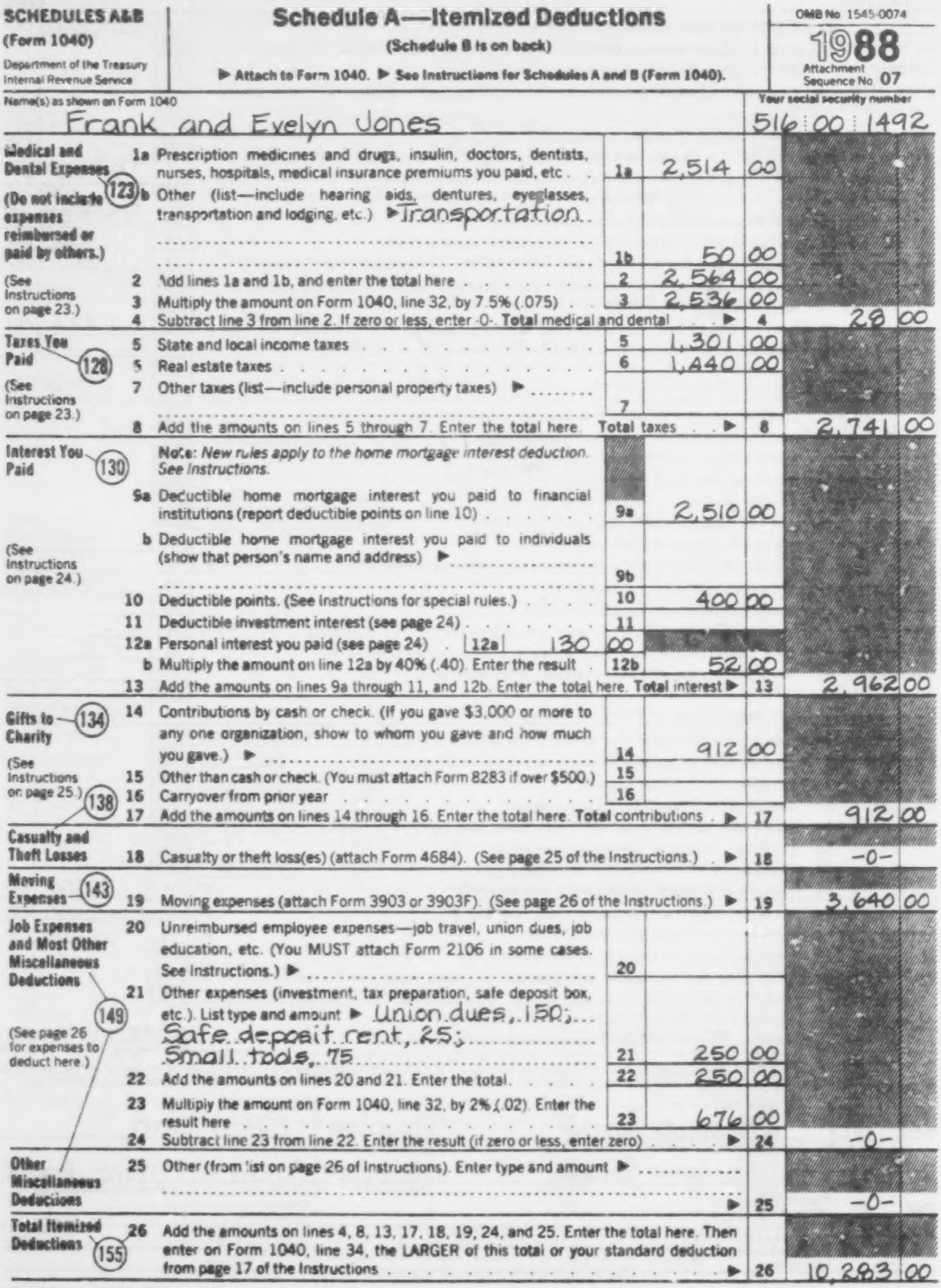
Your signature: Frank Jones	Date: 3-31-89	Your occupation: Electrician
Spouse's signature (if joint return, BOTH must sign): Evelyn Jones	Date: 3-31-89	Spouse's occupation: Co-Owner Travel Agency

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's social security no.
Firm's name (or yours if self-employed) and address ▶		E.I. No.	
		ZIP code	

Filled-in Schedule A

If you need more information, turn to the page shown in the circle.



SCHEDULES A&B (Form 1040)
Department of the Treasury
Internal Revenue Service

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No 1545-0074
1988
Attachment Sequence No 07

Name(s) as shown on Form 1040: Frank and Evelyn Jones

Your social security number: 516 00 1492

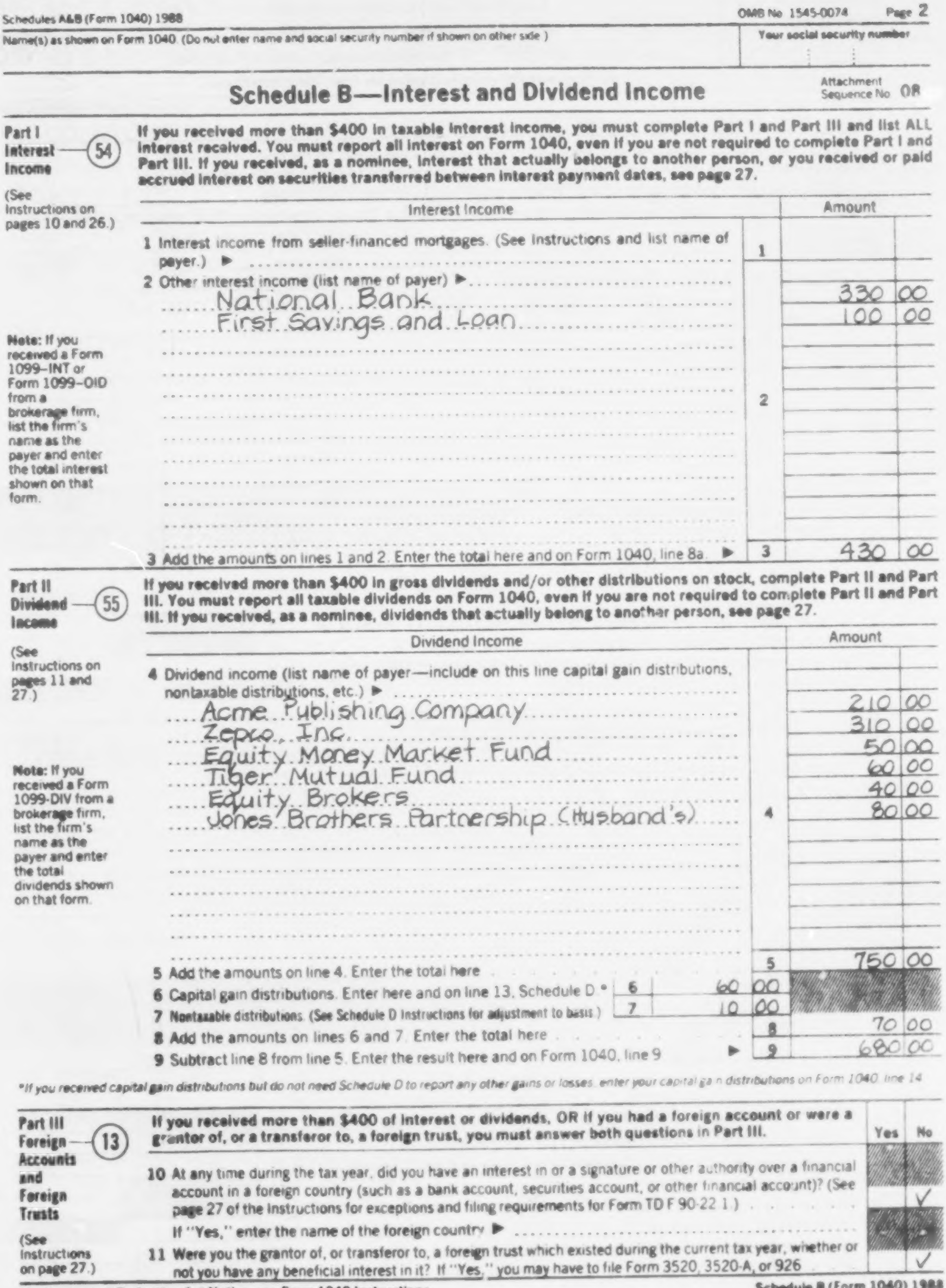
Medical and Dental Expenses (123) **(Do not include expenses reimbursed or paid by others.)**	1a	Prescription medicines and drugs, insulin, doctors, dentists, nurses, hospitals, medical insurance premiums you paid, etc	1a	2,514 00		
	b	Other (list—include hearing aids, dentures, eyeglasses, transportation and lodging, etc.) ▶ Transportation	1b	50 00		
(See Instructions on page 23.)	2	Add lines 1a and 1b, and enter the total here	2	2,564 00		
	3	Multiply the amount on Form 1040, line 32, by 7.5% (.075)	3	2,536 00		
	4	Subtract line 3 from line 2. If zero or less, enter -0-. **Total medical and dental** ▶			4	28 00
Taxes You Paid (128)	5	State and local income taxes	5	1,301 00		
(See Instructions on page 23.)	6	Real estate taxes	6	1,440 00		
	7	Other taxes (list—include personal property taxes) ▶	7			
	8	Add the amounts on lines 5 through 7. Enter the total here. **Total taxes** ▶			8	2,741 00
Interest You Paid (130)		**Note:** *New rules apply to the home mortgage interest deduction. See Instructions.*				
	9a	Deductible home mortgage interest you paid to financial institutions (report deductible points on line 10)	9a	2,510 00		
(See Instructions on page 24.)	b	Deductible home mortgage interest you paid to individuals (show that person's name and address) ▶	9b			
	10	Deductible points. (See Instructions for special rules.)	10	400 00		
	11	Deductible investment interest (see page 24)	11			
	12a	Personal interest you paid (see page 24) 12a 130 00				
	b	Multiply the amount on line 12a by 40% (.40). Enter the result	12b	52 00		
	13	Add the amounts on lines 9a through 11, and 12b. Enter the total here. **Total interest** ▶			13	2,962 00
Gifts to Charity (134)	14	Contributions by cash or check. (If you gave $3,000 or more to any one organization, show to whom you gave and how much you gave.) ▶	14	912 00		
(See Instructions on page 25.)	15	Other than cash or check. (You must attach Form 8283 if over $500.)	15			
(138)	16	Carryover from prior year	16			
	17	Add the amounts on lines 14 through 16. Enter the total here. **Total** contributions ▶			17	912 00
Casualty and Theft Losses	18	Casualty or theft loss(es) (attach Form 4684). (See page 25 of the Instructions.) ▶			18	-0-
Moving Expenses (143)	19	Moving expenses (attach Form 3903 or 3903F). (See page 26 of the Instructions.) ▶			19	3,640 00
Job Expenses and Most Other Miscellaneous Deductions (149)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. (You MUST attach Form 2106 in some cases. See Instructions.) ▶	20			
(See page 26 for expenses to deduct here.)	21	Other expenses (investment, tax preparation, safe deposit box, etc.). List type and amount ▶ Union dues, 150; Safe deposit rent, 25; Small tools, 75	21	250 00		
	22	Add the amounts on lines 20 and 21. Enter the total.	22	250 00		
	23	Multiply the amount on Form 1040, line 32, by 2% (.02). Enter the result here	23	676 00		
	24	Subtract line 23 from line 22. Enter the result (if zero or less, enter zero) ▶			24	-0-
Other Miscellaneous Deductions	25	Other (from list on page 26 of Instructions). Enter type and amount ▶			25	-0-
Total Itemized Deductions (155)	26	Add the amounts on lines 4, 8, 13, 17, 18, 19, 24, and 25. Enter the total here. Then enter on Form 1040, line 34, the LARGER of this total or your standard deduction from page 17 of the Instructions ▶			26	10,283 00

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule A (Form 1040) 1988

Filled-in Schedule B

If you need more information, turn to the page shown in the circle.



Schedules A&B (Form 1040) 1988 OMB No 1545-0074 Page 2

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side.) | Your social security number

Schedule B—Interest and Dividend Income

Attachment Sequence No 08

Part I Interest Income — (54)

(See instructions on pages 10 and 26.)

If you received more than $400 in taxable interest income, you must complete Part I and Part III and list ALL interest received. You must report all interest on Form 1040, even if you are not required to complete Part I and Part III. If you received, as a nominee, interest that actually belongs to another person, or you received or paid accrued interest on securities transferred between interest payment dates, see page 27.

Interest Income		Amount	
1 Interest income from seller-financed mortgages. (See instructions and list name of payer.) ▶	1		
2 Other interest income (list name of payer) ▶	2		
National Bank		330	00
First Savings and Loan		100	00
3 Add the amounts on lines 1 and 2. Enter the total here and on Form 1040, line 8a. ▶	3	430	00

Note: If you received a Form 1099-INT or Form 1099-OID from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Part II Dividend Income — (55)

(See instructions on pages 11 and 27.)

If you received more than $400 in gross dividends and/or other distributions on stock, complete Part II and Part III. You must report all taxable dividends on Form 1040, even if you are not required to complete Part II and Part III. If you received, as a nominee, dividends that actually belong to another person, see page 27.

Dividend Income				Amount	
4 Dividend income (list name of payer—include on this line capital gain distributions, nontaxable distributions, etc.) ▶			4		
Acme Publishing Company				210	00
Zepco, Inc.				310	00
Equity Money Market Fund				50	00
Tiger Mutual Fund				60	00
Equity Brokers				40	00
Jones Brothers Partnership (Husband's)				80	00
5 Add the amounts on line 4. Enter the total here			5	750	00
6 Capital gain distributions. Enter here and on line 13, Schedule D.*	6	60 00			
7 Nontaxable distributions. (See Schedule D instructions for adjustment to basis.)	7	10 00			
8 Add the amounts on lines 6 and 7. Enter the total here			8	70	00
9 Subtract line 8 from line 5. Enter the result here and on Form 1040, line 9 ▶			9	680	00

Note: If you received a Form 1099-DIV from a brokerage firm, list the firm's name as the payer and enter the total dividends shown on that form.

*If you received capital gain distributions but do not need Schedule D to report any other gains or losses, enter your capital gain distributions on Form 1040, line 14.

Part III Foreign Accounts and Foreign Trusts — ⑬

(See instructions on page 27.)

If you received more than $400 of interest or dividends, OR if you had a foreign account or were a grantor of, or a transferor to, a foreign trust, you must answer both questions in Part III.	Yes	No
10 At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See page 27 of the instructions for exceptions and filing requirements for Form TD F 90-22.1.)		✓
If "Yes," enter the name of the foreign country ▶		
11 Were you the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Form 3520, 3520-A, or 926		✓

For Paperwork Reduction Act Notice, see Form 1040 Instructions. **Schedule B (Form 1040) 1988**

best copy available

Filled–in Schedule D

If you need more information, turn to the page shown in the circle.

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses (96)

(And Reconciliation of Forms 1099-B)

▶ Attach to Form 1040. ▶ See instructions for Schedule D (Form 1040).

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

OMB No. 1545-0074

1988

Attachment Sequence No. 12

Name(s) as shown on Form 1040: Frank and Evelyn Jones

Your social security number: 516 00 1492

(91) 1 Report here the total sales of stocks, bonds, etc., reported for 1988 to you on Form(s) 1099-B or on equivalent substitute statement(s). If this amount differs from the total of lines 2b and 9b, column (d), attach a statement explaining the difference. See the instructions for line 1 for examples . . . 1 | 7,400 00

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less (6 months or less if acquired before 1/1/88)

(a) Description of property (Example, 100 shares 7% preferred of "Z" Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see instructions)	(e) Cost or other basis (see instructions)	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
2a Stocks, Bonds, and Other Securities (Include all Form 1099-B transactions. See Instructions.)						
100 sh. A Co.	12-7-87	5-6-88	800 00	1,100 00	300 00	
50 sh. B Co.	1-4-88	11-3-88	600 00	500 00		100 00
2b Total (add column (d)) . . . . 2b▶			1,400 00			
2c Other Transactions (Include Real Estate Transactions From Forms 1099-S)						
(91) Bad Debt (Worthless)					200 00	

		(f)	(g)
3 Short-term gain from sale or exchange of your home from Form 2119, line 8a or 14 (91)	3		
4 Short-term gain from installment sales from Form 6252, line 22 or 30 . . .	4		
5 Net short-term gain or (loss) from partnerships, S corporations, and fiduciaries (91)	5		
6 Short-term capital loss carryover (97) . . .	6	500 00	
7 Add all of the transactions on lines 2a and 2c and lines 3 through 6 in columns (f) and (g)	7	(1,000 00)	100 00
8 Net short-term gain or (loss), combine columns (f) and (g) of line 7 . . .	8		(900 00)

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year (more than 6 months if acquired before 1/1/88)

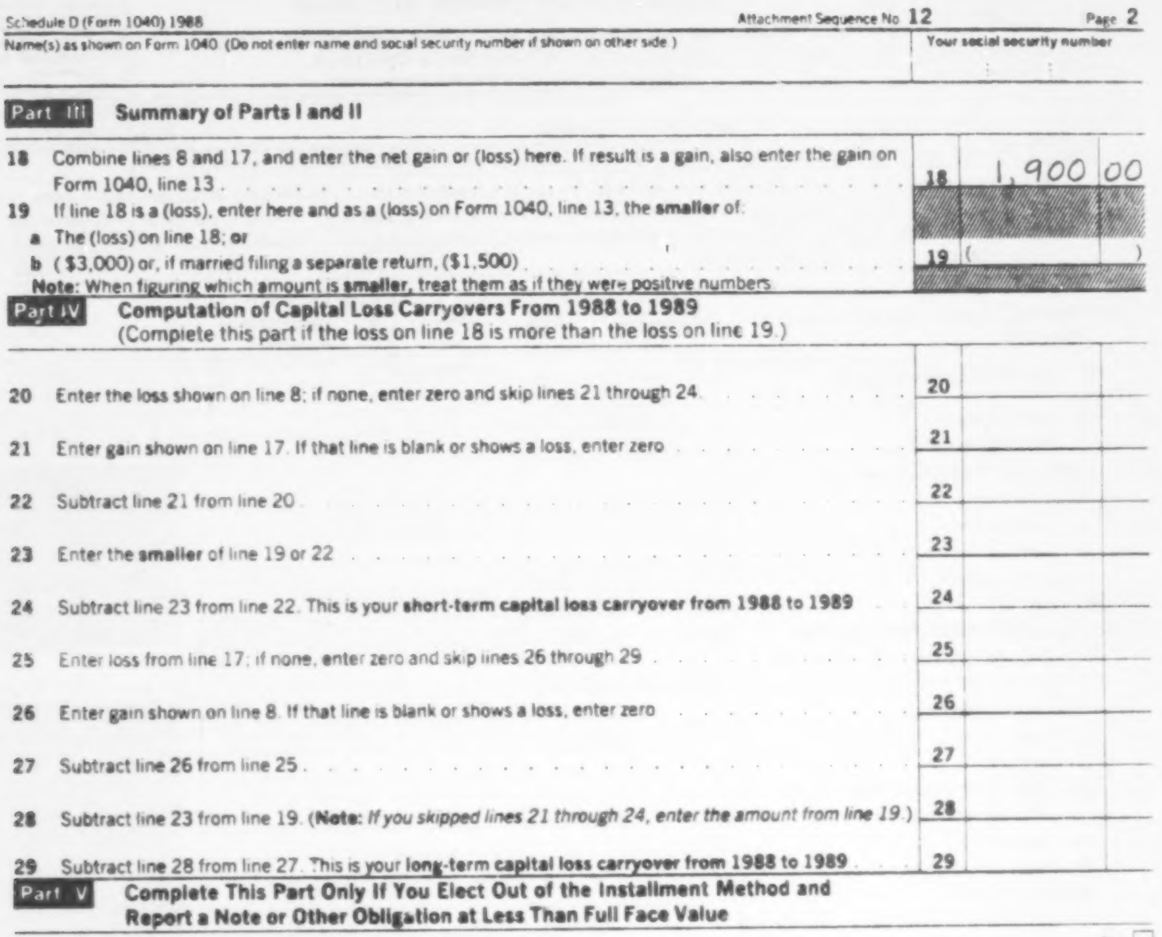
(a)	(b)	(c)	(d)	(e)	(f)	(g)
9a Stocks, Bonds, and Other Securities (Include all Form 1099-B transactions. See Instructions.)						
300 sh. XYZ Co	2-10-84	5-4-88	6,000 00	3,000 00		3,000 00
9b Total (add column (d)) . . . . 9b▶			6,000 00			
9c Other Transactions (Include Real Estate Transactions From Forms 1099-S)						
(87) D Co. Bond	11-30-87	7-29-88	Worthless		560 00	

		(f)	(g)
10 Long-term gain from sale or exchange of your home from Form 2119, line 8a, 10, or 14 (91)	10		
11 Long-term gain from installment sales from Form 6252, line 22 or 30	11		
12 Net long-term gain or (loss) from partnerships, S corporations, and fiduciaries .	12		300 00
13 Capital gain distributions (96) . . .	13		60 00
14 Enter gain from Form 4797, line 7 or 9 . . .	14		
15 Long-term capital loss carryover . . .	15		
16 Add all of the transactions on lines 9a and 9c and lines 10 through 15 in columns (f) and (g) .	16	(560 00)	3,360 00
17 Net long-term gain or (loss), combine columns (f) and (g) of line 16 . . .	17		2,800 00

Schedule D (Form 1040) 1988

Filled-in Schedule D

If you need more information, turn to the page shown in the circle.



Schedule D (Form 1040) 1988 Attachment Sequence No 12 Page 2

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side.) | Your social security number

Part III Summary of Parts I and II

18 Combine lines 8 and 17, and enter the net gain or (loss) here. If result is a gain, also enter the gain on Form 1040, line 13	18	1,900	00
19 If line 18 is a (loss), enter here and as a (loss) on Form 1040, line 13, the **smaller** of: a The (loss) on line 18; or b ($3,000) or, if married filing a separate return, ($1,500)	19	(	)

Note: When figuring which amount is **smaller**, treat them as if they were positive numbers.

Part IV Computation of Capital Loss Carryovers From 1988 to 1989
(Complete this part if the loss on line 18 is more than the loss on line 19.)

20 Enter the loss shown on line 8; if none, enter zero and skip lines 21 through 24	20		
21 Enter gain shown on line 17. If that line is blank or shows a loss, enter zero	21		
22 Subtract line 21 from line 20	22		
23 Enter the **smaller** of line 19 or 22	23		
24 Subtract line 23 from line 22. This is your **short-term capital loss carryover from 1988 to 1989**	24		
25 Enter loss from line 17; if none, enter zero and skip lines 26 through 29	25		
26 Enter gain shown on line 8. If that line is blank or shows a loss, enter zero	26		
27 Subtract line 26 from line 25	27		
28 Subtract line 23 from line 19. (**Note:** *If you skipped lines 21 through 24, enter the amount from line 19.*)	28		
29 Subtract line 28 from line 27. This is your **long-term capital loss carryover from 1988 to 1989**	29		

Part V Complete This Part Only If You Elect Out of the Installment Method and Report a Note or Other Obligation at Less Than Full Face Value

30 Check here if you elect out of the installment method ▶ ☐
31 Enter the face amount of the note or other obligation ▶
32 Enter the percentage of valuation of the note or other obligation ▶

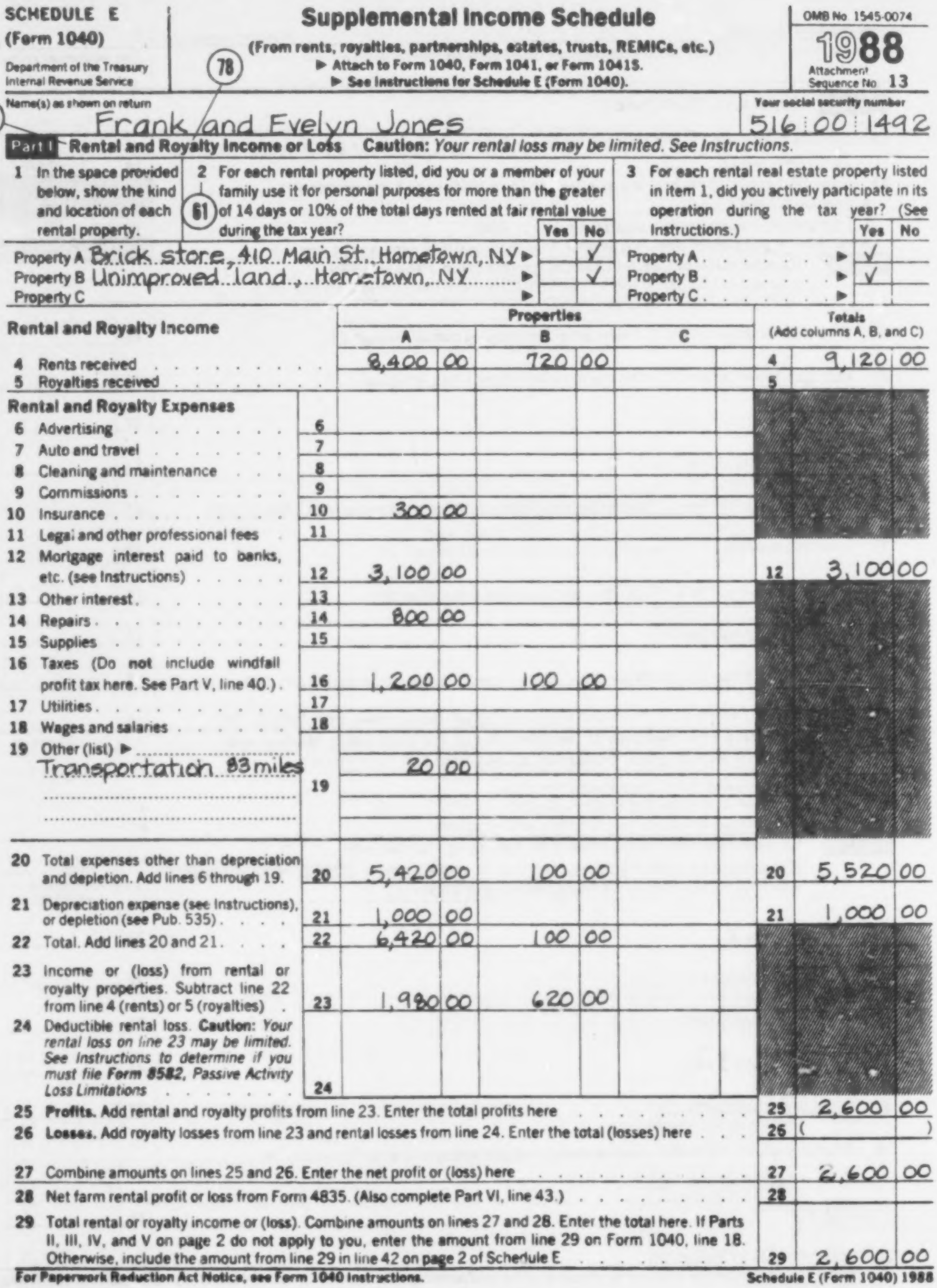
Part VI Reconciliation of Forms 1099-B for Bartering Transactions
(Complete this part if you received one or more Form(s) 1099-B or an equivalent substitute statement(s) reporting bartering income.)

		Amount of bartering income from Form 1099-B or equivalent statement reported on form or schedule	
33 Form 1040, line 22	33		
34 Schedule C (Form 1040)	34		
35 Schedule D (Form 1040)	35		
36 Schedule E (Form 1040)	36		
37 Schedule F (Form 1040)	37		
38 Other (identify) (if not taxable, indicate reason—attach additional sheets if necessary) ▶	38		
39 Total (add lines 33 through 38)	39		

Note: *The amount on line 39 should be the same as the total bartering income on all Forms 1099-B and equivalent statements received*

Filled-in Schedule E

If you need more information, turn to the page shown in the circle.



SCHEDULE E (Form 1040)
Department of the Treasury
Internal Revenue Service

Supplemental Income Schedule

(From rents, royalties, partnerships, estates, trusts, REMICs, etc.)
(78)
▶ Attach to Form 1040, Form 1041, or Form 1041S.
▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074
1988
Attachment Sequence No. 13

(60) Name(s) as shown on return: Frank and Evelyn Jones
Your social security number: 516 : 00 : 1492

Part I **Rental and Royalty Income or Loss** **Caution:** *Your rental loss may be limited. See Instructions.*

1 In the space provided below, show the kind and location of each rental property.

2 For each rental property listed, did you or a member of your family use it for personal purposes for more than the greater (61) of 14 days or 10% of the total days rented at fair rental value during the tax year?

3 For each rental real estate property listed in item 1, did you actively participate in its operation during the tax year? (See Instructions.)

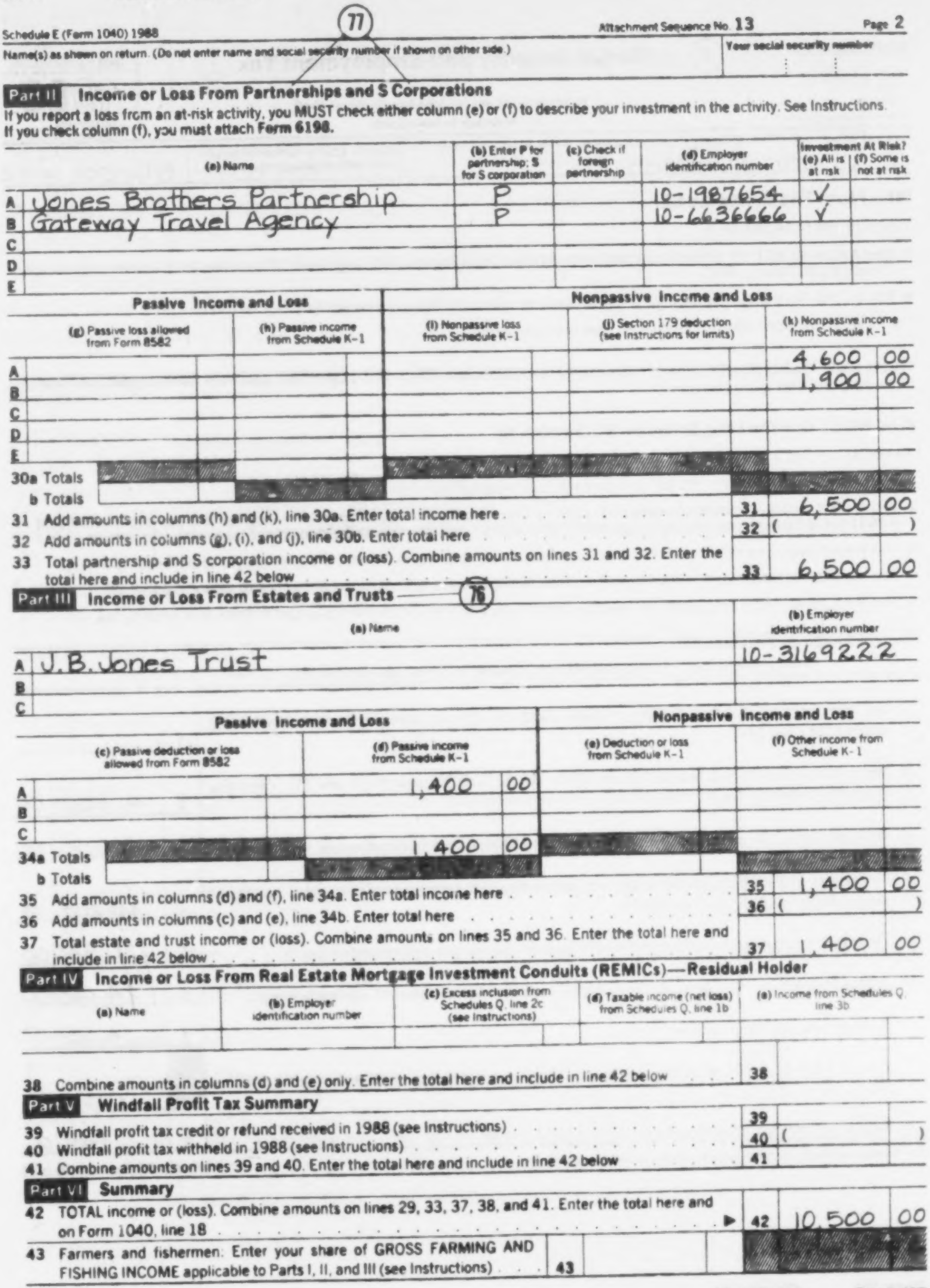
	2 Yes	2 No		3 Yes	3 No
Property A Brick store, 410 Main St. Hometown, NY ▶		✓	Property A . . . . . . ▶	✓	
Property B Unimproved land, Hometown, NY ▶		✓	Property B . . . . . . ▶	✓	
Property C ▶			Property C . . . . . . ▶		

		Properties							Totals (Add columns A, B, and C)	
		A		B		C				
Rental and Royalty Income										
4 Rents received		8,400	00	720	00			4	9,120	00
5 Royalties received								5		
Rental and Royalty Expenses										
6 Advertising	6									
7 Auto and travel	7									
8 Cleaning and maintenance	8									
9 Commissions	9									
10 Insurance	10	300	00							
11 Legal and other professional fees	11									
12 Mortgage interest paid to banks, etc. (see Instructions)	12	3,100	00					12	3,100	00
13 Other interest	13									
14 Repairs	14	800	00							
15 Supplies	15									
16 Taxes (Do **not** include windfall profit tax here. See Part V, line 40.)	16	1,200	00	100	00					
17 Utilities	17									
18 Wages and salaries	18									
19 Other (list) ▶ Transportation 83 miles	19	20	00							
20 Total expenses other than depreciation and depletion. Add lines 6 through 19.	20	5,420	00	100	00			20	5,520	00
21 Depreciation expense (see Instructions), or depletion (see Pub. 535)	21	1,000	00					21	1,000	00
22 Total. Add lines 20 and 21	22	6,420	00	100	00					
23 Income or (loss) from rental or royalty properties. Subtract line 22 from line 4 (rents) or 5 (royalties)	23	1,980	00	620	00					
24 Deductible rental loss. **Caution:** *Your rental loss on line 23 may be limited. See Instructions to determine if you must file* ***Form 8582****, Passive Activity Loss Limitations*	24									
25 **Profits.** Add rental and royalty profits from line 23. Enter the total profits here								25	2,600	00
26 **Losses.** Add royalty losses from line 23 and rental losses from line 24. Enter the total (losses) here								26	(	)
27 Combine amounts on lines 25 and 26. Enter the net profit or (loss) here								27	2,600	00
28 Net farm rental profit or loss from Form 4835. (Also complete Part VI, line 43.)								28		
29 Total rental or royalty income or (loss). Combine amounts on lines 27 and 28. Enter the total here. If Parts II, III, IV, and V on page 2 do not apply to you, enter the amount from line 29 on Form 1040, line 18. Otherwise, include the amount from line 29 in line 42 on page 2 of Schedule E								29	2,600	00

For Paperwork Reduction Act Notice, see Form 1040 Instructions. Schedule E (Form 1040) 1988

Filled–in Schedule E

If you need more information, turn to the page shown in the circle.



Schedule E (Form 1040) 1988 ⑺⑺ Attachment Sequence No. 13 Page 2

Name(s) as shown on return. (Do not enter name and social security number if shown on other side.) | Your social security number

Part II Income or Loss From Partnerships and S Corporations

If you report a loss from an at-risk activity, you MUST check either column (e) or (f) to describe your investment in the activity. See Instructions. If you check column (f), you must attach Form 6198.

	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	Investment At Risk? (e) All is at risk	(f) Some is not at risk
A	Jones Brothers Partnership	P		10-1987654	✓	
B	Gateway Travel Agency	P		10-6636666	✓	
C						
D						
E						

	Passive Income and Loss		Nonpassive Income and Loss		
	(g) Passive loss allowed from Form 8582	(h) Passive income from Schedule K-1	(i) Nonpassive loss from Schedule K-1	(j) Section 179 deduction (see Instructions for limits)	(k) Nonpassive income from Schedule K-1
A					4,600 00
B					1,900 00
C					
D					
E					
30a Totals	▨		▨	▨	
b Totals		▨			▨

31 Add amounts in columns (h) and (k), line 30a. Enter total income here	31	6,500 00
32 Add amounts in columns (g), (i), and (j), line 30b. Enter total here	32	( )
33 Total partnership and S corporation income or (loss). Combine amounts on lines 31 and 32. Enter the total here and include in line 42 below	33	6,500 00

Part III Income or Loss From Estates and Trusts ⑺⑹

	(a) Name	(b) Employer identification number
A	J.B. Jones Trust	10-3169222
B		
C		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed from Form 8582	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A		1,400 00		
B				
C				
34a Totals	▨	1,400 00	▨	
b Totals		▨		▨

35 Add amounts in columns (d) and (f), line 34a. Enter total income here	35	1,400 00
36 Add amounts in columns (c) and (e), line 34b. Enter total here	36	( )
37 Total estate and trust income or (loss). Combine amounts on lines 35 and 36. Enter the total here and include in line 42 below	37	1,400 00

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see Instructions)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b

38 Combine amounts in columns (d) and (e) only. Enter the total here and include in line 42 below	38	

Part V Windfall Profit Tax Summary

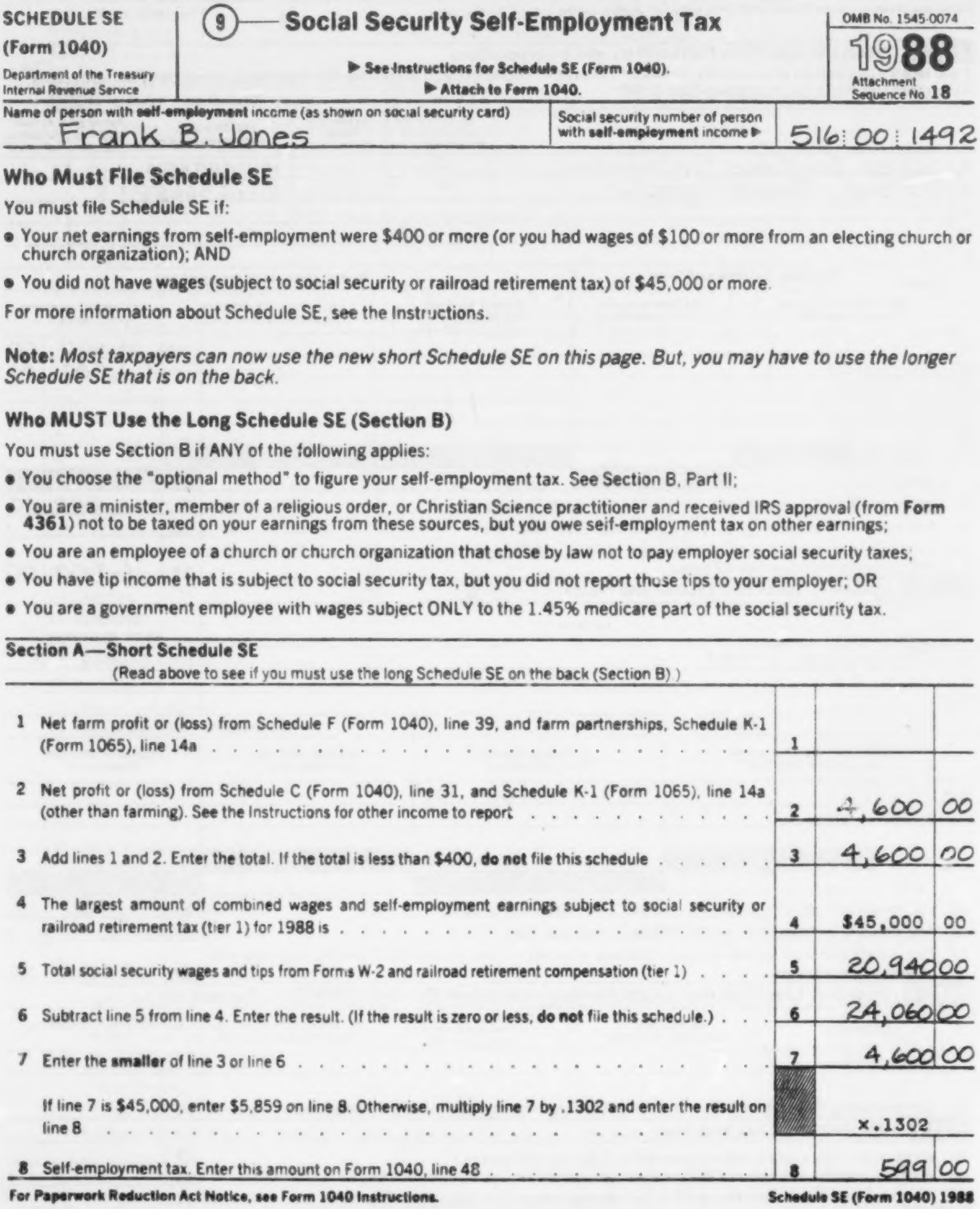
39 Windfall profit tax credit or refund received in 1988 (see Instructions)	39	
40 Windfall profit tax withheld in 1988 (see Instructions)	40	( )
41 Combine amounts on lines 39 and 40. Enter the total here and include in line 42 below	41	

Part VI Summary

42 TOTAL income or (loss). Combine amounts on lines 29, 33, 37, 38, and 41. Enter the total here and on Form 1040, line 18 ▶	42	10,500 00
43 Farmers and fishermen: Enter your share of GROSS FARMING AND FISHING INCOME applicable to Parts I, II, and III (see Instructions) 43		▨

Filled–in Schedule SE

If you need more information, turn to the page shown in the circle.



SCHEDULE SE
(Form 1040)
Department of the Treasury
Internal Revenue Service

⑨—**Social Security Self-Employment Tax**

▶ See Instructions for Schedule SE (Form 1040).
▶ Attach to Form 1040.

OMB No. 1545-0074
1988
Attachment Sequence No. 18

Name of person with **self-employment** income (as shown on social security card): Frank B. Jones

Social security number of person with **self-employment** income ▶ 516 : 00 : 1492

Who Must File Schedule SE

You must file Schedule SE if:

- Your net earnings from self-employment were $400 or more (or you had wages of $100 or more from an electing church or church organization); AND
- You did not have wages (subject to social security or railroad retirement tax) of $45,000 or more.

For more information about Schedule SE, see the Instructions.

Note: *Most taxpayers can now use the new short Schedule SE on this page. But, you may have to use the longer Schedule SE that is on the back.*

Who MUST Use the Long Schedule SE (Section B)

You must use Section B if ANY of the following applies:

- You choose the "optional method" to figure your self-employment tax. See Section B, Part II;
- You are a minister, member of a religious order, or Christian Science practitioner and received IRS approval (from **Form 4361**) not to be taxed on your earnings from these sources, but you owe self-employment tax on other earnings;
- You are an employee of a church or church organization that chose by law not to pay employer social security taxes;
- You have tip income that is subject to social security tax, but you did not report those tips to your employer; OR
- You are a government employee with wages subject ONLY to the 1.45% medicare part of the social security tax.

Section A—Short Schedule SE

(Read above to see if you must use the long Schedule SE on the back (Section B).)

1	Net farm profit or (loss) from Schedule F (Form 1040), line 39, and farm partnerships, Schedule K-1 (Form 1065), line 14a	1		
2	Net profit or (loss) from Schedule C (Form 1040), line 31, and Schedule K-1 (Form 1065), line 14a (other than farming). See the Instructions for other income to report	2	4,600	00
3	Add lines 1 and 2. Enter the total. If the total is less than $400, **do not** file this schedule	3	4,600	00
4	The largest amount of combined wages and self-employment earnings subject to social security or railroad retirement tax (tier 1) for 1988 is	4	$45,000	00
5	Total social security wages and tips from Forms W-2 and railroad retirement compensation (tier 1)	5	20,940	00
6	Subtract line 5 from line 4. Enter the result. (If the result is zero or less, **do not** file this schedule.)	6	24,060	00
7	Enter the **smaller** of line 3 or line 6	7	4,600	00
	If line 7 is $45,000, enter $5,859 on line 8. Otherwise, multiply line 7 by .1302 and enter the result on line 8		×.1302	
8	Self-employment tax. Enter this amount on Form 1040, line 48	8	599	00

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule SE (Form 1040) 1988

Filled-in Schedule SE

If you need more information, turn to the page shown in the circle.

SCHEDULE SE (Form 1040)
Department of the Treasury
Internal Revenue Service

⑨ **Social Security Self-Employment Tax**

▶ **See Instructions for Schedule SE (Form 1040).**
▶ **Attach to Form 1040.**

OMB No. 1545-0074
1988
Attachment Sequence No. 18

Name of person with **self-employment** income (as shown on social security card): Evelyn H. Jones

Social security number of person with **self-employment** income ▶ 575 : 00 : 1776

Who Must File Schedule SE

You must file Schedule SE if:

- Your net earnings from self-employment were $400 or more (or you had wages of $100 or more from an electing church or church organization); AND
- You did not have wages (subject to social security or railroad retirement tax) of $45,000 or more.

For more information about Schedule SE, see the Instructions.

Note: *Most taxpayers can now use the new short Schedule SE on this page. But, you may have to use the longer Schedule SE that is on the back.*

Who MUST Use the Long Schedule SE (Section B)

You must use Section B if ANY of the following applies:

- You choose the "optional method" to figure your self-employment tax. See Section B, Part II;
- You are a minister, member of a religious order, or Christian Science practitioner and received IRS approval (from **Form 4361**) not to be taxed on your earnings from these sources, but you owe self-employment tax on other earnings;
- You are an employee of a church or church organization that chose by law not to pay employer social security taxes;
- You have tip income that is subject to social security tax, but you did not report those tips to your employer; OR
- You are a government employee with wages subject ONLY to the 1.45% medicare part of the social security tax.

Section A—Short Schedule SE

(Read above to see if you must use the long Schedule SE on the back (Section B).)

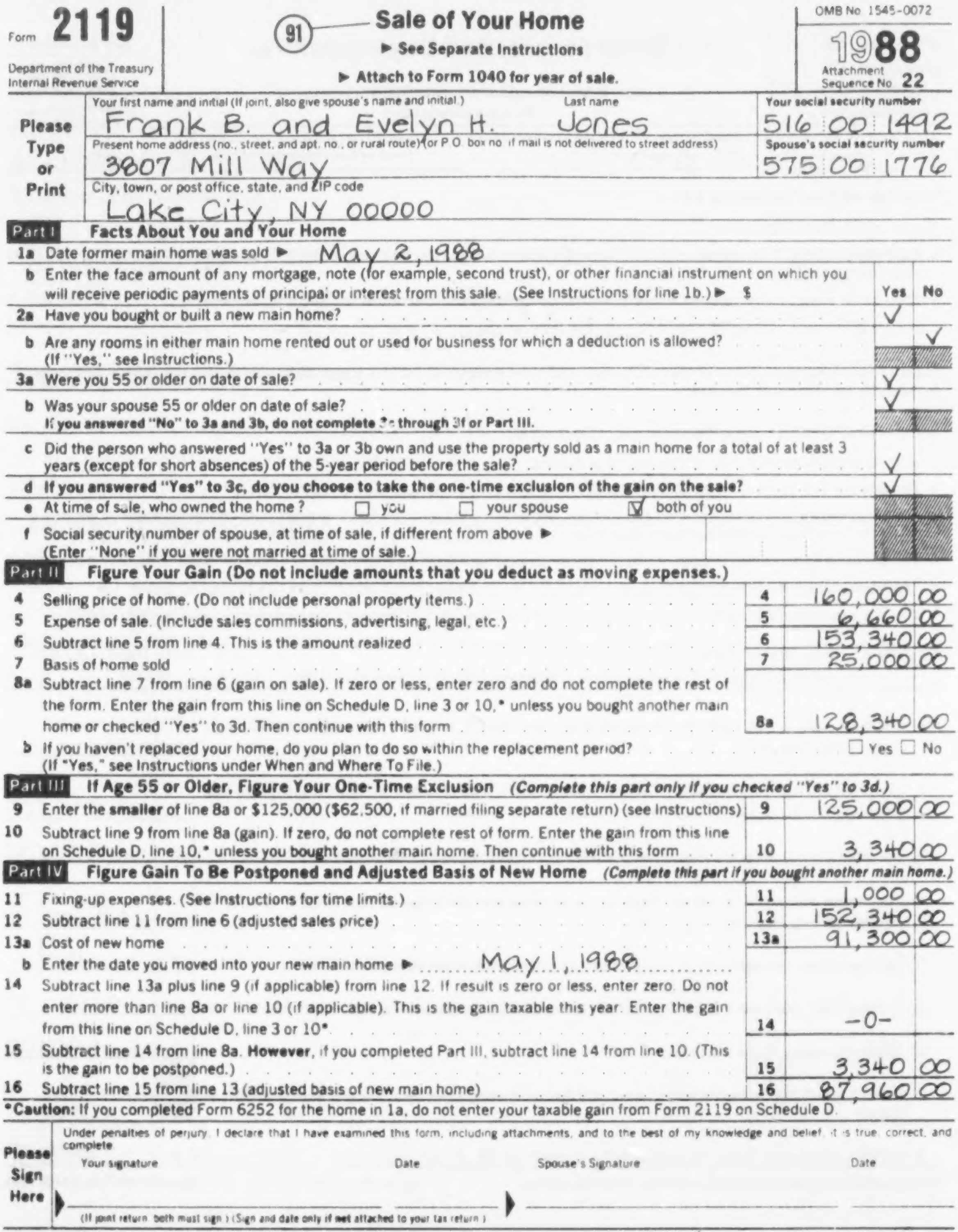
1	Net farm profit or (loss) from Schedule F (Form 1040), line 39, and farm partnerships, Schedule K-1 (Form 1065), line 14a	1		
2	Net profit or (loss) from Schedule C (Form 1040), line 31, and Schedule K-1 (Form 1065), line 14a (other than farming). See the Instructions for other income to report	2	1,900	00
3	Add lines 1 and 2. Enter the total. If the total is less than **$400**, **do not** file this schedule	3	1,900	00
4	The largest amount of combined wages and self-employment earnings subject to social security or railroad retirement tax (tier 1) for 1988 is	4	$45,000	00
5	Total social security wages and tips from Forms W-2 and railroad retirement compensation (tier 1)	5	-0-	
6	Subtract line 5 from line 4. Enter the result. (If the result is zero or less, **do not** file this schedule.)	6	45,000	00
7	Enter the **smaller** of line 3 or line 6	7	1,900	00
	If line 7 is $45,000, enter $5,859 on line 8. Otherwise, multiply line 7 by .1302 and enter the result on line 8		x.1302	
8	Self-employment tax. Enter this amount on Form 1040, line 48	8	247	00

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule SE (Form 1040) 1988

Filled-in Form 2119

If you need more information, turn to the page shown in the circle.



Form **2119**

Department of the Treasury
Internal Revenue Service

(91) **Sale of Your Home**

► **See Separate Instructions**

► **Attach to Form 1040 for year of sale.**

OMB No 1545-0072

1988

Attachment Sequence No **22**

Please Type or Print

Your first name and initial (If joint, also give spouse's name and initial.) Frank B. and Evelyn H.
Last name Jones
Your social security number 516 00 1492
Present home address (no., street, and apt. no., or rural route) (or P.O. box no. if mail is not delivered to street address) 3807 Mill Way
Spouse's social security number 575 00 1776
City, town, or post office, state, and ZIP code Lake City, NY 00000

Part I Facts About You and Your Home

		Yes	No
1a	Date former main home was sold ► May 2, 1988		
b	Enter the face amount of any mortgage, note (for example, second trust), or other financial instrument on which you will receive periodic payments of principal or interest from this sale. (See Instructions for line 1b.) ► $		
2a	Have you bought or built a new main home?	✓	
b	Are any rooms in either main home rented out or used for business for which a deduction is allowed? (If "Yes," see Instructions.)		✓
3a	Were you 55 or older on date of sale?	✓	
b	Was your spouse 55 or older on date of sale? **If you answered "No" to 3a and 3b, do not complete 3c through 3f or Part III.**	✓	
c	Did the person who answered "Yes" to 3a or 3b own and use the property sold as a main home for a total of at least 3 years (except for short absences) of the 5-year period before the sale?	✓	
d	**If you answered "Yes" to 3c, do you choose to take the one-time exclusion of the gain on the sale?**	✓	
e	At time of sale, who owned the home? ☐ you ☐ your spouse ☑ both of you		
f	Social security number of spouse, at time of sale, if different from above ► (Enter "None" if you were not married at time of sale.)		

Part II Figure Your Gain (Do not include amounts that you deduct as moving expenses.)

4	Selling price of home. (Do not include personal property items.)	4	160,000 00
5	Expense of sale. (Include sales commissions, advertising, legal, etc.)	5	6,660 00
6	Subtract line 5 from line 4. This is the amount realized	6	153,340 00
7	Basis of home sold	7	25,000 00
8a	Subtract line 7 from line 6 (gain on sale). If zero or less, enter zero and do not complete the rest of the form. Enter the gain from this line on Schedule D, line 3 or 10,* unless you bought another main home or checked "Yes" to 3d. Then continue with this form	8a	128,340 00
b	If you haven't replaced your home, do you plan to do so within the replacement period? (If "Yes," see Instructions under When and Where To File.) ☐ Yes ☐ No		

Part III If Age 55 or Older, Figure Your One-Time Exclusion ***(Complete this part only if you checked "Yes" to 3d.)***

9	Enter the **smaller** of line 8a or $125,000 ($62,500, if married filing separate return) (see Instructions)	9	125,000 00
10	Subtract line 9 from line 8a (gain). If zero, do not complete rest of form. Enter the gain from this line on Schedule D, line 10,* unless you bought another main home. Then continue with this form	10	3,340 00

Part IV Figure Gain To Be Postponed and Adjusted Basis of New Home ***(Complete this part if you bought another main home.)***

11	Fixing-up expenses. (See Instructions for time limits.)	11	1,000 00
12	Subtract line 11 from line 6 (adjusted sales price)	12	152,340 00
13a	Cost of new home	13a	91,300 00
b	Enter the date you moved into your new main home ► May 1, 1988		
14	Subtract line 13a plus line 9 (if applicable) from line 12. If result is zero or less, enter zero. Do not enter more than line 8a or line 10 (if applicable). This is the gain taxable this year. Enter the gain from this line on Schedule D, line 3 or 10*	14	-0-
15	Subtract line 14 from line 8a. **However**, if you completed Part III, subtract line 14 from line 10. (This is the gain to be postponed.)	15	3,340 00
16	Subtract line 15 from line 13 (adjusted basis of new main home)	16	87,960 00

***Caution:** If you completed Form 6252 for the home in 1a, do not enter your taxable gain from Form 2119 on Schedule D.

Please Sign Here

Under penalties of perjury, I declare that I have examined this form, including attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

Your signature ► Date ► Spouse's Signature Date

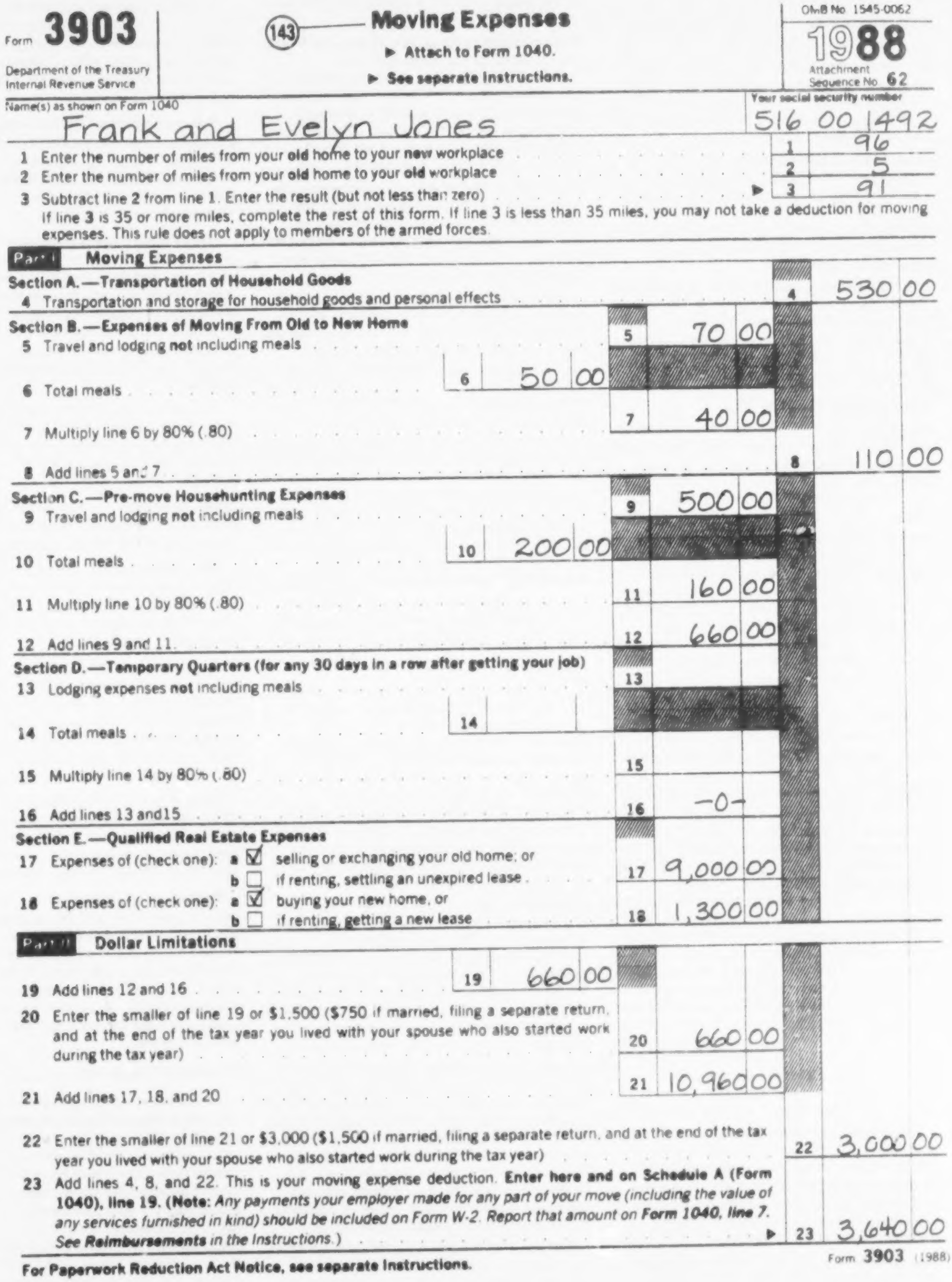
(If joint return, both must sign.) (Sign and date only if not attached to your tax return.)

For Paperwork Reduction Act Notice, see separate Instructions.

Form **2119** (1988)

Filled-in Form 3903

If you need more information, turn to the page shown in the circle.



Form **3903**
Department of the Treasury
Internal Revenue Service

(143) **Moving Expenses**
▶ Attach to Form 1040.
▶ See separate instructions.

OMB No. 1545-0062
1988
Attachment Sequence No. 62

Name(s) as shown on Form 1040: Frank and Evelyn Jones

Your social security number: 516 00 1492

1	Enter the number of miles from your **old** home to your **new** workplace	1	96
2	Enter the number of miles from your **old** home to your **old** workplace	2	5
3	Subtract line **2** from line 1. Enter the result (but not less than zero) ▶	3	91

If line **3** is 35 or more miles, complete the rest of this form. If line 3 is less than 35 miles, you may not take a deduction for moving expenses. This rule does not apply to members of the armed forces.

Part I Moving Expenses

	Section A.—Transportation of Household Goods				
4	Transportation and storage for household goods and personal effects			4	530 00
	Section B.—Expenses of Moving From Old to New Home				
5	Travel and lodging **not** including meals		5 70 00		
6	Total meals	6 50 00			
7	Multiply line 6 by 80% (.80)		7 40 00		
8	Add lines 5 and 7			8	110 00
	Section C.—Pre-move Househunting Expenses				
9	Travel and lodging **not** including meals		9 500 00		
10	Total meals	10 200 00			
11	Multiply line 10 by 80% (.80)		11 160 00		
12	Add lines 9 and 11		12 660 00		
	Section D.—Temporary Quarters (for any 30 days in a row after getting your job)				
13	Lodging expenses **not** including meals		13		
14	Total meals	14			
15	Multiply line 14 by 80% (.80)		15		
16	Add lines 13 and 15		16 -0-		
	Section E.—Qualified Real Estate Expenses				
17	Expenses of (check one): a ☑ selling or exchanging your old home; or b ☐ if renting, settling an unexpired lease		17 9,000 00		
18	Expenses of (check one): a ☑ buying your new home, or b ☐ if renting, getting a new lease		18 1,300 00		

Part II Dollar Limitations

19	Add lines 12 and 16	19 660 00			
20	Enter the smaller of line 19 or $1,500 ($750 if married, filing a separate return, and at the end of the tax year you lived with your spouse who also started work during the tax year)		20 660 00		
21	Add lines 17, 18, and 20		21 10,960 00		
22	Enter the smaller of line 21 or $3,000 ($1,500 if married, filing a separate return, and at the end of the tax year you lived with your spouse who also started work during the tax year)			22	3,000 00
23	Add lines 4, 8, and 22. This is your moving expense deduction. **Enter here and on Schedule A (Form 1040), line 19. (Note:** *Any payments your employer made for any part of your move (including the value of any services furnished in kind) should be included on Form W-2. Report that amount on* **Form 1040, line 7.** *See* **Reimbursements** *in the Instructions.*) ▶			23	3,640 00

For Paperwork Reduction Act Notice, see separate Instructions.

Form **3903** (1988)

The Examination and Appeals Process

We examine returns for correctness of income, exemptions, credits, and deductions.

Fairness if Your Return is Examined

Most taxpayers' returns are accepted as filed. But if your return is selected for examination, it does not suggest that you are dishonest. The examination may or may not result in more tax. Your case may be closed without change. Or, you may receive a refund.

Courtesy and consideration. You are entitled to courteous and considerate treatment from IRS employees at all times. If you ever feel that you are not being treated with fairness, courtesy, and consideration by an IRS employee, you should tell the employee's supervisor.

Pay only the required tax. You have the right to plan your business and personal finances in such a way that you will pay the least tax that is due under the law. You are liable only for the correct amount of tax. Our purpose is to apply the law consistently and fairly to all taxpayers.

Examination of Returns

An examination usually begins when we notify you that your return has been selected. We will tell you which records you will need. If you gather your records before the examination, it can be completed with the least amount of effort.

How returns are selected. We select returns for examination by several methods. A computer program called the Discriminant Function System (DIF) is used to select most returns. In this method, the computer uses historical data to give parts of the return a score. IRS personnel then screen the return. Returns most likely to have mistakes are selected for examination.

Some returns are selected at random. We use these examination results to update and improve our selection process.

We also select returns by examining claims for credit or refund and by matching information documents, such as Forms W–2 and 1099, with returns.

Arranging the examination. Many examinations are handled entirely by mail. For information on this, get Publication 1383, *The Correspondence Process (Income Tax Accounts)*, available free by calling the toll-free number shown near the end of this publication. If we notify you that your examination is to be conducted through a person-to-person interview, or if you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If the time or place we suggest is not convenient, the examiner will try to work out something more suitable. However, we will make the final decision on how, when, and where an examination takes place.

Transfers to another district. Generally, your return is examined in the IRS district where you live. But if your return can be examined more quickly and conveniently in another district, such as where your books and records are located, you may ask to have the case transferred to that district.

Representation. Throughout the examination, you may represent yourself, have someone else accompany you, or, with proper written authorization, have someone represent you in your absence.

Recordings. You may make a sound recording of the examination if you wish, if you let the examiner know in advance so that he or she may do the same.

Repeat examinations. We try to avoid repeat examinations of the same items, but sometimes this happens. If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so that we can see if we should discontinue the repeat examination.

Explanation of changes. If we propose any changes to your return, we will explain the reasons for the changes. It is important that you understand the reasons for any proposed change. You should not hesitate to ask about anything that is unclear to you.

Agreement with changes. If you agree with the proposed changes you may sign an agreement form and pay any additional tax you may owe. You must pay interest on any additional tax. If you pay when you sign the agreement, the interest is figured from the due date of your return to the date of your payment.

If you do not pay the additional tax when you sign the agreement, you will receive a bill. The interest on the additional tax is figured from the due date of your return to the billing date. However, you will not be billed for more than 30 days additional interest, even if the bill is delayed. Also, you will not have to pay any more interest or penalties if you pay the amount due within 10 days of the billing date.

If you are due a refund, we can refund your money more quickly if you sign the agreement form. You will be paid interest on the refund.

Appealing the Examination Findings

If you do not agree with the examiner's report, you may meet with the examiner's supervisor to discuss your case further. If you still don't agree with the examiner's findings, you have the right to appeal them. The examiner will explain your appeal rights and give you a copy of Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases.* This publication explains your appeal rights in detail and tells you exactly what to do if you want to appeal. You can also get a free copy by calling us at our toll-free number.

Appeals Office. You can appeal the findings of an examination within the IRS through our Appeals Office. The Appeals Office is independent of your examiner and IRS District Director. Most differences can be settled through this appeals system without expensive and time-consuming court trials. If the matter cannot be settled to your satisfaction in Appeals, you can take your case to court.

Appeals to the courts. Depending on whether you first pay the disputed tax, you can take your case to the U.S. Tax Court, the U.S. Claims Court, or your U.S. District Court. These courts are entirely independent of the IRS. However, a U.S. Tax Court case is generally reviewed by our Appeals Office before it is heard by the Tax Court. As always, you can represent yourself or have someone admitted to practice before the court represent you.

If you did not yet pay the additional tax and you disagree about whether you owe it, you generally have the right to take your case to the Tax Court. Ordinarily you have 90 days from the time we mail you a formal notice (called a "notice of deficiency") telling you that you owe additional tax to file a petition with the Tax Court.

If you have already paid the disputed tax in full and filed a claim for refund (discussed later) for it that we disallowed (or on which we did not take action within 6 months), then you may take your case to the U.S. District Court or U.S. Claims Court.

Court decisions. We follow Supreme Court decisions. However, we can lose cases in other courts involving taxpayers with the same issue and still apply our interpretation of the law to your situation. You have the right to appeal our decision to do so.

Recovering litigation expenses. If the court agrees with you on most of the issues in your case, and finds the IRS's position to be largely unjustified, you may be able to recover some of your litigation expenses from us. But to do this, you must have used up all the administrative remedies available to you within the IRS, including going through our Appeals system.

Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* will help you more fully understand your appeal rights. You can get it free by calling our toll-free number.

Other remedies. If you believe that tax, penalty, or interest was unjustly charged, you have rights which can remedy the situation.

Claims for refund. Once you have paid your tax, you have the right to file a claim for a credit or refund if you believe the tax is too much. The procedure for filing a claim is explained in Chapter 1.

Cancellation of penalties. You have the right to ask that certain penalties (but not interest, as discussed later) be cancelled (abated) if you can show reasonable cause for the failure that led to the penalty (or can show that you exercised due diligence, if that is the applicable standard for the penalty).

If you relied on wrong advice given to you by IRS employees on the toll-free telephone system, we will cancel certain penalties that may result. But you have to show that your reliance on the advice was reasonable.

Reduction of interest. If our error caused a delay in your case, and this is grossly unfair, you may be entitled to a reduction of the interest which would otherwise be due. Only delays caused by procedural or mechanical acts that do not involve exercising judgment or discretion qualify. If you think we caused such a delay, please discuss it with the examiner and file a claim.

Business Taxpayers

If you are in an individual business, the rights covered in this discussion generally apply to you. If you are a member of a partnership or a shareholder in a small business corporation, special rules (which may be different from those described here) may apply to the examination of your partnership or corporation items. The examination of these items is discussed in Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund.* You can get this publication free by calling us at our toll-free number.

1988 Tax Table

Use if your taxable income is less than $50,000. If $50,000 or more, use the Tax Rate Schedules.

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
$0	$5	$0	$0	$0	$0
5	15	2	2	2	2
15	25	3	3	3	3
25	50	6	6	6	6
50	75	9	9	9	9
75	100	13	13	13	13
100	125	17	17	17	17
125	150	21	21	21	21
150	175	24	24	24	24
175	200	28	28	28	28
200	225	32	32	32	32
225	250	36	36	36	36
250	275	39	39	39	39
275	300	43	43	43	43
300	325	47	47	47	47
325	350	51	51	51	51
350	375	54	54	54	54
375	400	58	58	58	58
400	425	62	62	62	62
425	450	66	66	66	66
450	475	69	69	69	69
475	500	73	73	73	73
500	525	77	77	77	77
525	550	81	81	81	81
550	575	84	84	84	84
575	600	88	88	88	88
600	625	92	92	92	92
625	650	96	96	96	96
650	675	99	99	99	99
675	700	103	103	103	103
700	725	107	107	107	107
725	750	111	111	111	111
750	775	114	114	114	114
775	800	118	118	118	118
800	825	122	122	122	122
825	850	126	126	126	126
850	875	129	129	129	129
875	900	133	133	133	133
900	925	137	137	137	137
925	950	141	141	141	141
950	975	144	144	144	144
975	1,000	148	148	148	148
1,000					
1,000	1,025	152	152	152	152
1,025	1,050	156	156	156	156
1,050	1,075	159	159	159	159
1,075	1,100	163	163	163	163
1,100	1,125	167	167	167	167
1,125	1,150	171	171	171	171
1,150	1,175	174	174	174	174
1,175	1,200	178	178	178	178
1,200	1,225	182	182	182	182
1,225	1,250	186	186	186	186
1,250	1,275	189	189	189	189
1,275	1,300	193	193	193	193
1,300	1,325	197	197	197	197
1,325	1,350	201	201	201	201
1,350	1,375	204	204	204	204
1,375	1,400	208	208	208	208
1,400	1,425	212	212	212	212
1,425	1,450	216	216	216	216
1,450	1,475	219	219	219	219
1,475	1,500	223	223	223	223
1,500	1,525	227	227	227	227
1,525	1,550	231	231	231	231
1,550	1,575	234	234	234	234
1,575	1,600	238	238	238	238
1,600	1,625	242	242	242	242
1,625	1,650	246	246	246	246
1,650	1,675	249	249	249	249
1,675	1,700	253	253	253	253
1,700	1,725	257	257	257	257
1,725	1,750	261	261	261	261
1,750	1,775	264	264	264	264
1,775	1,800	268	268	268	268
1,800	1,825	272	272	272	272
1,825	1,850	276	276	276	276
1,850	1,875	279	279	279	279
1,875	1,900	283	283	283	283
1,900	1,925	287	287	287	287
1,925	1,950	291	291	291	291
1,950	1,975	294	294	294	294
1,975	2,000	298	298	298	298
2,000					
2,000	2,025	302	302	302	302
2,025	2,050	306	306	306	306
2,050	2,075	309	309	309	309
2,075	2,100	313	313	313	313
2,100	2,125	317	317	317	317
2,125	2,150	321	321	321	321
2,150	2,175	324	324	324	324
2,175	2,200	328	328	328	328
2,200	2,225	332	332	332	332
2,225	2,250	336	336	336	336
2,250	2,275	339	339	339	339
2,275	2,300	343	343	343	343
2,300	2,325	347	347	347	347
2,325	2,350	351	351	351	351
2,350	2,375	354	354	354	354
2,375	2,400	358	358	358	358
2,400	2,425	362	362	362	362
2,425	2,450	366	366	366	366
2,450	2,475	369	369	369	369
2,475	2,500	373	373	373	373
2,500	2,525	377	377	377	377
2,525	2,550	381	381	381	381
2,550	2,575	384	384	384	384
2,575	2,600	388	388	388	388
2,600	2,625	392	392	392	392
2,625	2,650	396	396	396	396
2,650	2,675	399	399	399	399
2,675	2,700	403	403	403	403
2,700	2,725	407	407	407	407
2,725	2,750	411	411	411	411
2,750	2,775	414	414	414	414
2,775	2,800	418	418	418	418
2,800	2,825	422	422	422	422
2,825	2,850	426	426	426	426
2,850	2,875	429	429	429	429
2,875	2,900	433	433	433	433
2,900	2,925	437	437	437	437
2,925	2,950	441	441	441	441
2,950	2,975	444	444	444	444
2,975	3,000	448	448	448	448
3,000					
3,000	3,050	454	454	454	454
3,050	3,100	461	461	461	461
3,100	3,150	469	469	469	469
3,150	3,200	476	476	476	476
3,200	3,250	484	484	484	484
3,250	3,300	491	491	491	491
3,300	3,350	499	499	499	499
3,350	3,400	506	506	506	506
3,400	3,450	514	514	514	514
3,450	3,500	521	521	521	521
3,500	3,550	529	529	529	529
3,550	3,600	536	536	536	536
3,600	3,650	544	544	544	544
3,650	3,700	551	551	551	551
3,700	3,750	559	559	559	559
3,750	3,800	566	566	566	566
3,800	3,850	574	574	574	574
3,850	3,900	581	581	581	581
3,900	3,950	589	589	589	589
3,950	4,000	596	596	596	596
4,000					
4,000	4,050	604	604	604	604
4,050	4,100	611	611	611	611
4,100	4,150	619	619	619	619
4,150	4,200	626	626	626	626
4,200	4,250	634	634	634	634
4,250	4,300	641	641	641	641
4,300	4,350	649	649	649	649
4,350	4,400	656	656	656	656
4,400	4,450	664	664	664	664
4,450	4,500	671	671	671	671
4,500	4,550	679	679	679	679
4,550	4,600	686	686	686	686
4,600	4,650	694	694	694	694
4,650	4,700	701	701	701	701
4,700	4,750	709	709	709	709
4,750	4,800	716	716	716	716
4,800	4,850	724	724	724	724
4,850	4,900	731	731	731	731
4,900	4,950	739	739	739	739
4,950	5,000	746	746	746	746

* This column must also be used by a qualifying widow(er).

Continued on next page

1988 Tax Table—*Continued*

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
5,000					
5,000	5,050	754	754	754	754
5,050	5,100	761	761	761	761
5,100	5,150	769	769	769	769
5,150	5,200	776	776	776	776
5,200	5,250	784	784	784	784
5,250	5,300	791	791	791	791
5,300	5,350	799	799	799	799
5,350	5,400	806	806	806	806
5,400	5,450	814	814	814	814
5,450	5,500	821	821	821	821
5,500	5,550	829	829	829	829
5,550	5,600	836	836	836	836
5,600	5,650	844	844	844	844
5,650	5,700	851	851	851	851
5,700	5,750	859	859	859	859
5,750	5,800	866	866	866	866
5,800	5,850	874	874	874	874
5,850	5,900	881	881	881	881
5,900	5,950	889	889	889	889
5,950	6,000	896	896	896	896
6,000					
6,000	6,050	904	904	904	904
6,050	6,100	911	911	911	911
6,100	6,150	919	919	919	919
6,150	6,200	926	926	926	926
6,200	6,250	934	934	934	934
6,250	6,300	941	941	941	941
6,300	6,350	949	949	949	949
6,350	6,400	956	956	956	956
6,400	6,450	964	964	964	964
6,450	6,500	971	971	971	971
6,500	6,550	979	979	979	979
6,550	6,600	986	986	986	986
6,600	6,650	994	994	994	994
6,650	6,700	1,001	1,001	1,001	1,001
6,700	6,750	1,009	1,009	1,009	1,009
6,750	6,800	1,016	1,016	1,016	1,016
6,800	6,850	1,024	1,024	1,024	1,024
6,850	6,900	1,031	1,031	1,031	1,031
6,900	6,950	1,039	1,039	1,039	1,039
6,950	7,000	1,046	1,046	1,046	1,046
7,000					
7,000	7,050	1,054	1,054	1,054	1,054
7,050	7,100	1,061	1,061	1,061	1,061
7,100	7,150	1,069	1,069	1,069	1,069
7,150	7,200	1,076	1,076	1,076	1,076
7,200	7,250	1,084	1,084	1,084	1,084
7,250	7,300	1,091	1,091	1,091	1,091
7,300	7,350	1,099	1,099	1,099	1,099
7,350	7,400	1,106	1,106	1,106	1,106
7,400	7,450	1,114	1,114	1,114	1,114
7,450	7,500	1,121	1,121	1,121	1,121
7,500	7,550	1,129	1,129	1,129	1,129
7,550	7,600	1,136	1,136	1,136	1,136
7,600	7,650	1,144	1,144	1,144	1,144
7,650	7,700	1,151	1,151	1,151	1,151
7,700	7,750	1,159	1,159	1,159	1,159
7,750	7,800	1,166	1,166	1,166	1,166
7,800	7,850	1,174	1,174	1,174	1,174
7,850	7,900	1,181	1,181	1,181	1,181
7,900	7,950	1,189	1,189	1,189	1,189
7,950	8,000	1,196	1,196	1,196	1,196

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
8,000					
8,000	8,050	1,204	1,204	1,204	1,204
8,050	8,100	1,211	1,211	1,211	1,211
8,100	8,150	1,219	1,219	1,219	1,219
8,150	8,200	1,226	1,226	1,226	1,226
8,200	8,250	1,234	1,234	1,234	1,234
8,250	8,300	1,241	1,241	1,241	1,241
8,300	8,350	1,249	1,249	1,249	1,249
8,350	8,400	1,256	1,256	1,256	1,256
8,400	8,450	1,264	1,264	1,264	1,264
8,450	8,500	1,271	1,271	1,271	1,271
8,500	8,550	1,279	1,279	1,279	1,279
8,550	8,600	1,286	1,286	1,286	1,286
8,600	8,650	1,294	1,294	1,294	1,294
8,650	8,700	1,301	1,301	1,301	1,301
8,700	8,750	1,309	1,309	1,309	1,309
8,750	8,800	1,316	1,316	1,316	1,316
8,800	8,850	1,324	1,324	1,324	1,324
8,850	8,900	1,331	1,331	1,331	1,331
8,900	8,950	1,339	1,339	1,339	1,339
8,950	9,000	1,346	1,346	1,346	1,346
9,000					
9,000	9,050	1,354	1,354	1,354	1,354
9,050	9,100	1,361	1,361	1,361	1,361
9,100	9,150	1,369	1,369	1,369	1,369
9,150	9,200	1,376	1,376	1,376	1,376
9,200	9,250	1,384	1,384	1,384	1,384
9,250	9,300	1,391	1,391	1,391	1,391
9,300	9,350	1,399	1,399	1,399	1,399
9,350	9,400	1,406	1,406	1,406	1,406
9,400	9,450	1,414	1,414	1,414	1,414
9,450	9,500	1,421	1,421	1,421	1,421
9,500	9,550	1,429	1,429	1,429	1,429
9,550	9,600	1,436	1,436	1,436	1,436
9,600	9,650	1,444	1,444	1,444	1,444
9,650	9,700	1,451	1,451	1,451	1,451
9,700	9,750	1,459	1,459	1,459	1,459
9,750	9,800	1,466	1,466	1,466	1,466
9,800	9,850	1,474	1,474	1,474	1,474
9,850	9,900	1,481	1,481	1,481	1,481
9,900	9,950	1,489	1,489	1,489	1,489
9,950	10,000	1,496	1,496	1,496	1,496
10,000					
10,000	10,050	1,504	1,504	1,504	1,504
10,050	10,100	1,511	1,511	1,511	1,511
10,100	10,150	1,519	1,519	1,519	1,519
10,150	10,200	1,526	1,526	1,526	1,526
10,200	10,250	1,534	1,534	1,534	1,534
10,250	10,300	1,541	1,541	1,541	1,541
10,300	10,350	1,549	1,549	1,549	1,549
10,350	10,400	1,556	1,556	1,556	1,556
10,400	10,450	1,564	1,564	1,564	1,564
10,450	10,500	1,571	1,571	1,571	1,571
10,500	10,550	1,579	1,579	1,579	1,579
10,550	10,600	1,586	1,586	1,586	1,586
10,600	10,650	1,594	1,594	1,594	1,594
10,650	10,700	1,601	1,601	1,601	1,601
10,700	10,750	1,609	1,609	1,609	1,609
10,750	10,800	1,616	1,616	1,616	1,616
10,800	10,850	1,624	1,624	1,624	1,624
10,850	10,900	1,631	1,631	1,631	1,631
10,900	10,950	1,639	1,639	1,639	1,639
10,950	11,000	1,646	1,646	1,646	1,646

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
11,000					
11,000	11,050	1,654	1,654	1,654	1,654
11,050	11,100	1,661	1,661	1,661	1,661
11,100	11,150	1,669	1,669	1,669	1,669
11,150	11,200	1,676	1,676	1,676	1,676
11,200	11,250	1,684	1,684	1,684	1,684
11,250	11,300	1,691	1,691	1,691	1,691
11,300	11,350	1,699	1,699	1,699	1,699
11,350	11,400	1,706	1,706	1,706	1,706
11,400	11,450	1,714	1,714	1,714	1,714
11,450	11,500	1,721	1,721	1,721	1,721
11,500	11,550	1,729	1,729	1,729	1,729
11,550	11,600	1,736	1,736	1,736	1,736
11,600	11,650	1,744	1,744	1,744	1,744
11,650	11,700	1,751	1,751	1,751	1,751
11,700	11,750	1,759	1,759	1,759	1,759
11,750	11,800	1,766	1,766	1,766	1,766
11,800	11,850	1,774	1,774	1,774	1,774
11,850	11,900	1,781	1,781	1,781	1,781
11,900	11,950	1,789	1,789	1,789	1,789
11,950	12,000	1,796	1,796	1,796	1,796
12,000					
12,000	12,050	1,804	1,804	1,804	1,804
12,050	12,100	1,811	1,811	1,811	1,811
12,100	12,150	1,819	1,819	1,819	1,819
12,150	12,200	1,826	1,826	1,826	1,826
12,200	12,250	1,834	1,834	1,834	1,834
12,250	12,300	1,841	1,841	1,841	1,841
12,300	12,350	1,849	1,849	1,849	1,849
12,350	12,400	1,856	1,856	1,856	1,856
12,400	12,450	1,864	1,864	1,864	1,864
12,450	12,500	1,871	1,871	1,871	1,871
12,500	12,550	1,879	1,879	1,879	1,879
12,550	12,600	1,886	1,886	1,886	1,886
12,600	12,650	1,894	1,894	1,894	1,894
12,650	12,700	1,901	1,901	1,901	1,901
12,700	12,750	1,909	1,909	1,909	1,909
12,750	12,800	1,916	1,916	1,916	1,916
12,800	12,850	1,924	1,924	1,924	1,924
12,850	12,900	1,931	1,931	1,931	1,931
12,900	12,950	1,939	1,939	1,939	1,939
12,950	13,000	1,946	1,946	1,946	1,946
13,000					
13,000	13,050	1,954	1,954	1,954	1,954
13,050	13,100	1,961	1,961	1,961	1,961
13,100	13,150	1,969	1,969	1,969	1,969
13,150	13,200	1,976	1,976	1,976	1,976
13,200	13,250	1,984	1,984	1,984	1,984
13,250	13,300	1,991	1,991	1,991	1,991
13,300	13,350	1,999	1,999	1,999	1,999
13,350	13,400	2,006	2,006	2,006	2,006
13,400	13,450	2,014	2,014	2,014	2,014
13,450	13,500	2,021	2,021	2,021	2,021
13,500	13,550	2,029	2,029	2,029	2,029
13,550	13,600	2,036	2,036	2,036	2,036
13,600	13,650	2,044	2,044	2,044	2,044
13,650	13,700	2,051	2,051	2,051	2,051
13,700	13,750	2,059	2,059	2,059	2,059
13,750	13,800	2,066	2,066	2,066	2,066
13,800	13,850	2,074	2,074	2,074	2,074
13,850	13,900	2,081	2,081	2,081	2,081
13,900	13,950	2,089	2,089	2,089	2,089
13,950	14,000	2,096	2,096	2,096	2,096

* This column must also be used by a qualifying widow(er).

Continued on next page

1988 Tax Table—*Continued*

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
14,000					
14,000	14,050	2,104	2,104	2,104	2,104
14,050	14,100	2,111	2,111	2,111	2,111
14,100	14,150	2,119	2,119	2,119	2,119
14,150	14,200	2,126	2,126	2,126	2,126
14,200	14,250	2,134	2,134	2,134	2,134
14,250	14,300	2,141	2,141	2,141	2,141
14,300	14,350	2,149	2,149	2,149	2,149
14,350	14,400	2,156	2,156	2,156	2,156
14,400	14,450	2,164	2,164	2,164	2,164
14,450	14,500	2,171	2,171	2,171	2,171
14,500	14,550	2,179	2,179	2,179	2,179
14,550	14,600	2,186	2,186	2,186	2,186
14,600	14,650	2,194	2,194	2,194	2,194
14,650	14,700	2,201	2,201	2,201	2,201
14,700	14,750	2,209	2,209	2,209	2,209
14,750	14,800	2,216	2,216	2,216	2,216
14,800	14,850	2,224	2,224	2,224	2,224
14,850	14,900	2,231	2,231	2,231	2,231
14,900	14,950	2,239	2,239	2,245	2,239
14,950	15,000	2,246	2,246	2,259	2,246
15,000					
15,000	15,050	2,254	2,254	2,273	2,254
15,050	15,100	2,261	2,261	2,287	2,261
15,100	15,150	2,269	2,269	2,301	2,269
15,150	15,200	2,276	2,276	2,315	2,276
15,200	15,250	2,284	2,284	2,329	2,284
15,250	15,300	2,291	2,291	2,343	2,291
15,300	15,350	2,299	2,299	2,357	2,299
15,350	15,400	2,306	2,306	2,371	2,306
15,400	15,450	2,314	2,314	2,385	2,314
15,450	15,500	2,321	2,321	2,399	2,321
15,500	15,550	2,329	2,329	2,413	2,329
15,550	15,600	2,336	2,336	2,427	2,336
15,600	15,650	2,344	2,344	2,441	2,344
15,650	15,700	2,351	2,351	2,455	2,351
15,700	15,750	2,359	2,359	2,469	2,359
15,750	15,800	2,366	2,366	2,483	2,366
15,800	15,850	2,374	2,374	2,497	2,374
15,850	15,900	2,381	2,381	2,511	2,381
15,900	15,950	2,389	2,389	2,525	2,389
15,950	16,000	2,396	2,396	2,539	2,396
16,000					
16,000	16,050	2,404	2,404	2,553	2,404
16,050	16,100	2,411	2,411	2,567	2,411
16,100	16,150	2,419	2,419	2,581	2,419
16,150	16,200	2,426	2,426	2,595	2,426
16,200	16,250	2,434	2,434	2,609	2,434
16,250	16,300	2,441	2,441	2,623	2,441
16,300	16,350	2,449	2,449	2,637	2,449
16,350	16,400	2,456	2,456	2,651	2,456
16,400	16,450	2,464	2,464	2,665	2,464
16,450	16,500	2,471	2,471	2,679	2,471
16,500	16,550	2,479	2,479	2,693	2,479
16,550	16,600	2,486	2,486	2,707	2,486
16,600	16,650	2,494	2,494	2,721	2,494
16,650	16,700	2,501	2,501	2,735	2,501
16,700	16,750	2,509	2,509	2,749	2,509
16,750	16,800	2,516	2,516	2,763	2,516
16,800	16,850	2,524	2,524	2,777	2,524
16,850	16,900	2,531	2,531	2,791	2,531
16,900	16,950	2,539	2,539	2,805	2,539
16,950	17,000	2,546	2,546	2,819	2,546
17,000					
17,000	17,050	2,554	2,554	2,833	2,554
17,050	17,100	2,561	2,561	2,847	2,561
17,100	17,150	2,569	2,569	2,861	2,569
17,150	17,200	2,576	2,576	2,875	2,576
17,200	17,250	2,584	2,584	2,889	2,584
17,250	17,300	2,591	2,591	2,903	2,591
17,300	17,350	2,599	2,599	2,917	2,599
17,350	17,400	2,606	2,606	2,931	2,606
17,400	17,450	2,614	2,614	2,945	2,614
17,450	17,500	2,621	2,621	2,959	2,621
17,500	17,550	2,629	2,629	2,973	2,629
17,550	17,600	2,636	2,636	2,987	2,636
17,600	17,650	2,644	2,644	3,001	2,644
17,650	17,700	2,651	2,651	3,015	2,651
17,700	17,750	2,659	2,659	3,029	2,659
17,750	17,800	2,666	2,666	3,043	2,666
17,800	17,850	2,674	2,674	3,057	2,674
17,850	17,900	2,685	2,681	3,071	2,681
17,900	17,950	2,699	2,689	3,085	2,689
17,950	18,000	2,713	2,696	3,099	2,696
18,000					
18,000	18,050	2,727	2,704	3,113	2,704
18,050	18,100	2,741	2,711	3,127	2,711
18,100	18,150	2,755	2,719	3,141	2,719
18,150	18,200	2,769	2,726	3,155	2,726
18,200	18,250	2,783	2,734	3,169	2,734
18,250	18,300	2,797	2,741	3,183	2,741
18,300	18,350	2,811	2,749	3,197	2,749
18,350	18,400	2,825	2,756	3,211	2,756
18,400	18,450	2,839	2,764	3,225	2,764
18,450	18,500	2,853	2,771	3,239	2,771
18,500	18,550	2,867	2,779	3,253	2,779
18,550	18,600	2,881	2,786	3,267	2,786
18,600	18,650	2,895	2,794	3,281	2,794
18,650	18,700	2,909	2,801	3,295	2,801
18,700	18,750	2,923	2,809	3,309	2,809
18,750	18,800	2,937	2,816	3,323	2,816
18,800	18,850	2,951	2,824	3,337	2,824
18,850	18,900	2,965	2,831	3,351	2,831
18,900	18,950	2,979	2,839	3,365	2,839
18,950	19,000	2,993	2,846	3,379	2,846
19,000					
19,000	19,050	3,007	2,854	3,393	2,854
19,050	19,100	3,021	2,861	3,407	2,861
19,100	19,150	3,035	2,869	3,421	2,869
19,150	19,200	3,049	2,876	3,435	2,876
19,200	19,250	3,063	2,884	3,449	2,884
19,250	19,300	3,077	2,891	3,463	2,891
19,300	19,350	3,091	2,899	3,477	2,899
19,350	19,400	3,105	2,906	3,491	2,906
19,400	19,450	3,119	2,914	3,505	2,914
19,450	19,500	3,133	2,921	3,519	2,921
19,500	19,550	3,147	2,929	3,533	2,929
19,550	19,600	3,161	2,936	3,547	2,936
19,600	19,650	3,175	2,944	3,561	2,944
19,650	19,700	3,189	2,951	3,575	2,951
19,700	19,750	3,203	2,959	3,589	2,959
19,750	19,800	3,217	2,966	3,603	2,966
19,800	19,850	3,231	2,974	3,617	2,974
19,850	19,900	3,245	2,981	3,631	2,981
19,900	19,950	3,259	2,989	3,645	2,989
19,950	20,000	3,273	2,996	3,659	2,996
20,000					
20,000	20,050	3,287	3,004	3,673	3,004
20,050	20,100	3,301	3,011	3,687	3,011
20,100	20,150	3,315	3,019	3,701	3,019
20,150	20,200	3,329	3,026	3,715	3,026
20,200	20,250	3,343	3,034	3,729	3,034
20,250	20,300	3,357	3,041	3,743	3,041
20,300	20,350	3,371	3,049	3,757	3,049
20,350	20,400	3,385	3,056	3,771	3,056
20,400	20,450	3,399	3,064	3,785	3,064
20,450	20,500	3,413	3,071	3,799	3,071
20,500	20,550	3,427	3,079	3,813	3,079
20,550	20,600	3,441	3,086	3,827	3,086
20,600	20,650	3,455	3,094	3,841	3,094
20,650	20,700	3,469	3,101	3,855	3,101
20,700	20,750	3,483	3,109	3,869	3,109
20,750	20,800	3,497	3,116	3,883	3,116
20,800	20,850	3,511	3,124	3,897	3,124
20,850	20,900	3,525	3,131	3,911	3,131
20,900	20,950	3,539	3,139	3,925	3,139
20,950	21,000	3,553	3,146	3,939	3,146
21,000					
21,000	21,050	3,567	3,154	3,953	3,154
21,050	21,100	3,581	3,161	3,967	3,161
21,100	21,150	3,595	3,169	3,981	3,169
21,150	21,200	3,609	3,176	3,995	3,176
21,200	21,250	3,623	3,184	4,009	3,184
21,250	21,300	3,637	3,191	4,023	3,191
21,300	21,350	3,651	3,199	4,037	3,199
21,350	21,400	3,665	3,206	4,051	3,206
21,400	21,450	3,679	3,214	4,065	3,214
21,450	21,500	3,693	3,221	4,079	3,221
21,500	21,550	3,707	3,229	4,093	3,229
21,550	21,600	3,721	3,236	4,107	3,236
21,600	21,650	3,735	3,244	4,121	3,244
21,650	21,700	3,749	3,251	4,135	3,251
21,700	21,750	3,763	3,259	4,149	3,259
21,750	21,800	3,777	3,266	4,163	3,266
21,800	21,850	3,791	3,274	4,177	3,274
21,850	21,900	3,805	3,281	4,191	3,281
21,900	21,950	3,819	3,289	4,205	3,289
21,950	22,000	3,833	3,296	4,219	3,296
22,000					
22,000	22,050	3,847	3,304	4,233	3,304
22,050	22,100	3,861	3,311	4,247	3,311
22,100	22,150	3,875	3,319	4,261	3,319
22,150	22,200	3,889	3,326	4,275	3,326
22,200	22,250	3,903	3,334	4,289	3,334
22,250	22,300	3,917	3,341	4,303	3,341
22,300	22,350	3,931	3,349	4,317	3,349
22,350	22,400	3,945	3,356	4,331	3,356
22,400	22,450	3,959	3,364	4,345	3,364
22,450	22,500	3,973	3,371	4,359	3,371
22,500	22,550	3,987	3,379	4,373	3,379
22,550	22,600	4,001	3,386	4,387	3,386
22,600	22,650	4,015	3,394	4,401	3,394
22,650	22,700	4,029	3,401	4,415	3,401
22,700	22,750	4,043	3,409	4,429	3,409
22,750	22,800	4,057	3,416	4,443	3,416
22,800	22,850	4,071	3,424	4,457	3,424
22,850	22,900	4,085	3,431	4,471	3,431
22,900	22,950	4,099	3,439	4,485	3,439
22,950	23,000	4,113	3,446	4,499	3,446

* This column must also be used by a qualifying widow(er).

Continued on next page

1988 Tax Table—*Continued*

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
23,000					
23,000	**23,050**	4,127	3,454	4,513	3,454
23,050	**23,100**	4,141	3,461	4,527	3,461
23,100	**23,150**	4,155	3,469	4,541	3,469
23,150	**23,200**	4,169	3,476	4,555	3,476
23,200	**23,250**	4,183	3,484	4,569	3,484
23,250	**23,300**	4,197	3,491	4,583	3,491
23,300	**23,350**	4,211	3,499	4,597	3,499
23,350	**23,400**	4,225	3,506	4,611	3,506
23,400	**23,450**	4,239	3,514	4,625	3,514
23,450	**23,500**	4,253	3,521	4,639	3,521
23,500	**23,550**	4,267	3,529	4,653	3,529
23,550	**23,600**	4,281	3,536	4,667	3,536
23,600	**23,650**	4,295	3,544	4,681	3,544
23,650	**23,700**	4,309	3,551	4,695	3,551
23,700	**23,750**	4,323	3,559	4,709	3,559
23,750	**23,800**	4,337	3,566	4,723	3,566
23,800	**23,850**	4,351	3,574	4,737	3,574
23,850	**23,900**	4,365	3,581	4,751	3,581
23,900	**23,950**	4,379	3,589	4,765	3,592
23,950	**24,000**	4,393	3,596	4,779	3,606
24,000					
24,000	**24,050**	4,407	3,604	4,793	3,620
24,050	**24,100**	4,421	3,611	4,807	3,634
24,100	**24,150**	4,435	3,619	4,821	3,648
24,150	**24,200**	4,449	3,626	4,835	3,662
24,200	**24,250**	4,463	3,634	4,849	3,676
24,250	**24,300**	4,477	3,641	4,863	3,690
24,300	**24,350**	4,491	3,649	4,877	3,704
24,350	**24,400**	4,505	3,656	4,891	3,718
24,400	**24,450**	4,519	3,664	4,905	3,732
24,450	**24,500**	4,533	3,671	4,919	3,746
24,500	**24,550**	4,547	3,679	4,933	3,760
24,550	**24,600**	4,561	3,686	4,947	3,774
24,600	**24,650**	4,575	3,694	4,961	3,788
24,650	**24,700**	4,589	3,701	4,975	3,802
24,700	**24,750**	4,603	3,709	4,989	3,816
24,750	**24,800**	4,617	3,716	5,003	3,830
24,800	**24,850**	4,631	3,724	5,017	3,844
24,850	**24,900**	4,645	3,731	5,031	3,858
24,900	**24,950**	4,659	3,739	5,045	3,872
24,950	**25,000**	4,673	3,746	5,059	3,886
25,000					
25,000	**25,050**	4,687	3,754	5,073	3,900
25,050	**25,100**	4,701	3,761	5,087	3,914
25,100	**25,150**	4,715	3,769	5,101	3,928
25,150	**25,200**	4,729	3,776	5,115	3,942
25,200	**25,250**	4,743	3,784	5,129	3,956
25,250	**25,300**	4,757	3,791	5,143	3,970
25,300	**25,350**	4,771	3,799	5,157	3,984
25,350	**25,400**	4,785	3,806	5,171	3,998
25,400	**25,450**	4,799	3,814	5,185	4,012
25,450	**25,500**	4,813	3,821	5,199	4,026
25,500	**25,550**	4,827	3,829	5,213	4,040
25,550	**25,600**	4,841	3,836	5,227	4,054
25,600	**25,650**	4,855	3,844	5,241	4,068
25,650	**25,700**	4,869	3,851	5,255	4,082
25,700	**25,750**	4,883	3,859	5,269	4,096
25,750	**25,800**	4,897	3,866	5,283	4,110
25,800	**25,850**	4,911	3,874	5,297	4,124
25,850	**25,900**	4,925	3,881	5,311	4,138
25,900	**25,950**	4,939	3,889	5,325	4,152
25,950	**26,000**	4,953	3,896	5,339	4,166
26,000					
26,000	**26,050**	4,967	3,904	5,353	4,180
26,050	**26,100**	4,981	3,911	5,367	4,194
26,100	**26,150**	4,995	3,919	5,381	4,208
26,150	**26,200**	5,009	3,926	5,395	4,222
26,200	**26,250**	5,023	3,934	5,409	4,236
26,250	**26,300**	5,037	3,941	5,423	4,250
26,300	**26,350**	5,051	3,949	5,437	4,264
26,350	**26,400**	5,065	3,956	5,451	4,278
26,400	**26,450**	5,079	3,964	5,465	4,292
26,450	**26,500**	5,093	3,971	5,479	4,306
26,500	**26,550**	5,107	3,979	5,493	4,320
26,550	**26,600**	5,121	3,986	5,507	4,334
26,600	**26,650**	5,135	3,994	5,521	4,348
26,650	**26,700**	5,149	4,001	5,535	4,362
26,700	**26,750**	5,163	4,009	5,549	4,376
26,750	**26,800**	5,177	4,016	5,563	4,390
26,800	**26,850**	5,191	4,024	5,577	4,404
26,850	**26,900**	5,205	4,031	5,591	4,418
26,900	**26,950**	5,219	4,039	5,605	4,432
26,950	**27,000**	5,233	4,046	5,619	4,446
27,000					
27,000	**27,050**	5,247	4,054	5,633	4,460
27,050	**27,100**	5,261	4,061	5,647	4,474
27,100	**27,150**	5,275	4,069	5,661	4,488
27,150	**27,200**	5,289	4,076	5,675	4,502
27,200	**27,250**	5,303	4,084	5,689	4,516
27,250	**27,300**	5,317	4,091	5,703	4,530
27,300	**27,350**	5,331	4,099	5,717	4,544
27,350	**27,400**	5,345	4,106	5,731	4,558
27,400	**27,450**	5,359	4,114	5,745	4,572
27,450	**27,500**	5,373	4,121	5,759	4,586
27,500	**27,550**	5,387	4,129	5,773	4,600
27,550	**27,600**	5,401	4,136	5,787	4,614
27,600	**27,650**	5,415	4,144	5,801	4,628
27,650	**27,700**	5,429	4,151	5,815	4,642
27,700	**27,750**	5,443	4,159	5,829	4,656
27,750	**27,800**	5,457	4,166	5,843	4,670
27,800	**27,850**	5,471	4,174	5,857	4,684
27,850	**27,900**	5,485	4,181	5,871	4,698
27,900	**27,950**	5,499	4,189	5,885	4,712
27,950	**28,000**	5,513	4,196	5,899	4,726
28,000					
28,000	**28,050**	5,527	4,204	5,913	4,740
28,050	**28,100**	5,541	4,211	5,927	4,754
28,100	**28,150**	5,555	4,219	5,941	4,768
28,150	**28,200**	5,569	4,226	5,955	4,782
28,200	**28,250**	5,583	4,234	5,969	4,796
28,250	**28,300**	5,597	4,241	5,983	4,810
28,300	**28,350**	5,611	4,249	5,997	4,824
28,350	**28,400**	5,625	4,256	6,011	4,838
28,400	**28,450**	5,639	4,264	6,025	4,852
28,450	**28,500**	5,653	4,271	6,039	4,866
28,500	**28,550**	5,667	4,279	6,053	4,880
28,550	**28,600**	5,681	4,286	6,067	4,894
28,600	**28,650**	5,695	4,294	6,081	4,908
28,650	**28,700**	5,709	4,301	6,095	4,922
28,700	**28,750**	5,723	4,309	6,109	4,936
28,750	**28,800**	5,737	4,316	6,123	4,950
28,800	**28,850**	5,751	4,324	6,137	4,964
28,850	**28,900**	5,765	4,331	6,151	4,978
28,900	**28,950**	5,779	4,339	6,165	4,992
28,950	**29,000**	5,793	4,346	6,179	5,006
29,000					
29,000	**29,050**	5,807	4,354	6,193	5,020
29,050	**29,100**	5,821	4,361	6,207	5,034
29,100	**29,150**	5,835	4,369	6,221	5,048
29,150	**29,200**	5,849	4,376	6,235	5,062
29,200	**29,250**	5,863	4,384	6,249	5,076
29,250	**29,300**	5,877	4,391	6,263	5,090
29,300	**29,350**	5,891	4,399	6,277	5,104
29,350	**29,400**	5,905	4,406	6,291	5,118
29,400	**29,450**	5,919	4,414	6,305	5,132
29,450	**29,500**	5,933	4,421	6,319	5,146
29,500	**29,550**	5,947	4,429	6,333	5,160
29,550	**29,600**	5,961	4,436	6,347	5,174
29,600	**29,650**	5,975	4,444	6,361	5,188
29,650	**29,700**	5,989	4,451	6,375	5,202
29,700	**29,750**	6,003	4,459	6,389	5,216
29,750	**29,800**	6,017	4,470	6,403	5,230
29,800	**29,850**	6,031	4,484	6,417	5,244
29,850	**29,900**	6,045	4,498	6,431	5,258
29,900	**29,950**	6,059	4,512	6,445	5,272
29,950	**30,000**	6,073	4,526	6,459	5,286
30,000					
30,000	**30,050**	6,087	4,540	6,473	5,300
30,050	**30,100**	6,101	4,554	6,487	5,314
30,100	**30,150**	6,115	4,568	6,501	5,328
30,150	**30,200**	6,129	4,582	6,515	5,342
30,200	**30,250**	6,143	4,596	6,529	5,356
30,250	**30,300**	6,157	4,610	6,543	5,370
30,300	**30,350**	6,171	4,624	6,557	5,384
30,350	**30,400**	6,185	4,638	6,571	5,398
30,400	**30,450**	6,199	4,652	6,585	5,412
30,450	**30,500**	6,213	4,666	6,599	5,426
30,500	**30,550**	6,227	4,680	6,613	5,440
30,550	**30,600**	6,241	4,694	6,627	5,454
30,600	**30,650**	6,255	4,708	6,641	5,468
30,650	**30,700**	6,269	4,722	6,655	5,482
30,700	**30,750**	6,283	4,736	6,669	5,496
30,750	**30,800**	6,297	4,750	6,683	5,510
30,800	**30,850**	6,311	4,764	6,697	5,524
30,850	**30,900**	6,325	4,778	6,711	5,538
30,900	**30,950**	6,339	4,792	6,725	5,552
30,950	**31,000**	6,353	4,806	6,739	5,566
31,000					
31,000	**31,050**	6,367	4,820	6,753	5,580
31,050	**31,100**	6,381	4,834	6,767	5,594
31,100	**31,150**	6,395	4,848	6,781	5,608
31,150	**31,200**	6,409	4,862	6,795	5,622
31,200	**31,250**	6,423	4,876	5,809	5,636
31,250	**31,300**	6,437	4,890	6,823	5,650
31,300	**31,350**	6,451	4,904	6,837	5,664
31,350	**31,400**	6,465	4,918	6,851	5,678
31,400	**31,450**	6,479	4,932	6,865	5,692
31,450	**31,500**	6,493	4,946	6,879	5,706
31,500	**31,550**	6,507	4,960	6,893	5,720
31,550	**31,600**	6,521	4,974	6,907	5,734
31,600	**31,650**	6,535	4,988	6,921	5,748
31,650	**31,700**	6,549	5,002	6,935	5,762
31,700	**31,750**	6,563	5,016	6,949	5,776
31,750	**31,800**	6,577	5,030	6,963	5,790
31,800	**31,850**	6,591	5,044	6,977	5,804
31,850	**31,900**	6,605	5,058	6,991	5,818
31,900	**31,950**	6,619	5,072	7,005	5,832
31,950	**32,000**	6,633	5,086	7,019	5,846

* This column must also be used by a qualifying widow(er).

Continued on next page

1988 Tax Table—*Continued*

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
32,000					
32,000	32,050	6,647	5,100	7,033	5,860
32,050	32,100	6,661	5,114	7,047	5,874
32,100	32,150	6,675	5,128	7,061	5,888
32,150	32,200	6,689	5,142	7,075	5,902
32,200	32,250	6,703	5,156	7,089	5,916
32,250	32,300	6,717	5,170	7,103	5,930
32,300	32,350	6,731	5,184	7,117	5,944
32,350	32,400	6,745	5,198	7,131	5,958
32,400	32,450	6,759	5,212	7,145	5,972
32,450	32,500	6,773	5,226	7,159	5,986
32,500	32,550	6,787	5,240	7,173	6,000
32,550	32,600	6,801	5,254	7,187	6,014
32,600	32,650	6,815	5,268	7,201	6,028
32,650	32,700	6,829	5,282	7,215	6,042
32,700	32,750	6,843	5,296	7,229	6,056
32,750	32,800	6,857	5,310	7,243	6,070
32,800	32,850	6,871	5,324	7,257	6,084
32,850	32,900	6,885	5,338	7,271	6,098
32,900	32,950	6,899	5,352	7,285	6,112
32,950	33,000	6,913	5,366	7,299	6,126
33,000					
33,000	33,050	6,927	5,380	7,313	6,140
33,050	33,100	6,941	5,394	7,327	6,154
33,100	33,150	6,955	5,408	7,341	6,168
33,150	33,200	6,969	5,422	7,355	6,182
33,200	33,250	6,983	5,436	7,369	6,196
33,250	33,300	6,997	5,450	7,383	6,210
33,300	33,350	7,011	5,464	7,397	6,224
33,350	33,400	7,025	5,478	7,411	6,238
33,400	33,450	7,039	5,492	7,425	6,252
33,450	33,500	7,053	5,506	7,439	6,266
33,500	33,550	7,067	5,520	7,453	6,280
33,550	33,600	7,081	5,534	7,467	6,294
33,600	33,650	7,095	5,548	7,481	6,308
33,650	33,700	7,109	5,562	7,495	6,322
33,700	33,750	7,123	5,576	7,509	6,336
33,750	33,800	7,137	5,590	7,523	6,350
33,800	33,850	7,151	5,604	7,537	6,364
33,850	33,900	7,165	5,618	7,551	6,378
33,900	33,950	7,179	5,632	7,565	6,392
33,950	34,000	7,193	5,646	7,579	6,406
34,000					
34,000	34,050	7,207	5,660	7,593	6,420
34,050	34,100	7,221	5,674	7,607	6,434
34,100	34,150	7,235	5,688	7,621	6,448
34,150	34,200	7,249	5,702	7,635	6,462
34,200	34,250	7,263	5,716	7,649	6,476
34,250	34,300	7,277	5,730	7,663	6,490
34,300	34,350	7,291	5,744	7,677	6,504
34,350	34,400	7,305	5,758	7,691	6,518
34,400	34,450	7,319	5,772	7,705	6,532
34,450	34,500	7,333	5,786	7,719	6,546
34,500	34,550	7,347	5,800	7,733	6,560
34,550	34,600	7,361	5,814	7,747	6,574
34,600	34,650	7,375	5,828	7,761	6,588
34,650	34,700	7,389	5,842	7,775	6,602
34,700	34,750	7,403	5,856	7,789	6,616
34,750	34,800	7,417	5,870	7,803	6,630
34,800	34,850	7,431	5,884	7,817	6,644
34,850	34,900	7,445	5,898	7,831	6,658
34,900	34,950	7,459	5,912	7,845	6,672
34,950	35,000	7,473	5,926	7,859	6,686

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
35,000					
35,000	35,050	7,487	5,940	7,873	6,700
35,050	35,100	7,501	5,954	7,887	6,714
35,100	35,150	7,515	5,968	7,901	6,728
35,150	35,200	7,529	5,982	7,915	6,742
35,200	35,250	7,543	5,996	7,929	6,756
35,250	35,300	7,557	6,010	7,943	6,770
35,300	35,350	7,571	6,024	7,957	6,784
35,350	35,400	7,585	6,038	7,971	6,798
35,400	35,450	7,599	6,052	7,985	6,812
35,450	35,500	7,613	6,066	7,999	6,826
35,500	35,550	7,627	6,080	8,013	6,840
35,550	35,600	7,641	6,094	8,027	6,854
35,600	35,650	7,655	6,108	8,041	6,868
35,650	35,700	7,669	6,122	8,055	6,882
35,700	35,750	7,683	6,136	8,069	6,896
35,750	35,800	7,697	6,150	8,083	6,910
35,800	35,850	7,711	6,164	8,097	6,924
35,850	35,900	7,725	6,178	8,111	6,938
35,900	35,950	7,739	6,192	8,125	6,952
35,950	36,000	7,753	6,206	8,141	6,966
36,000					
36,000	36,050	7,767	6,220	8,157	6,980
36,050	36,100	7,781	6,234	8,174	6,994
36,100	36,150	7,795	6,248	8,190	7,008
36,150	36,200	7,809	6,262	8,207	7,022
36,200	36,250	7,823	6,276	8,223	7,036
36,250	36,300	7,837	6,290	8,240	7,050
36,300	36,350	7,851	6,304	8,256	7,064
36,350	36,400	7,865	6,318	8,273	7,078
36,400	36,450	7,879	6,332	8,289	7,092
36,450	36,500	7,893	6,346	8,306	7,106
36,500	36,550	7,907	6,360	8,322	7,120
36,550	36,600	7,921	6,374	8,339	7,134
36,600	36,650	7,935	6,388	8,355	7,148
36,650	36,700	7,949	6,402	8,372	7,162
36,700	36,750	7,963	6,416	8,388	7,176
36,750	36,800	7,977	6,430	8,405	7,190
36,800	36,850	7,991	6,444	8,421	7,204
36,850	36,900	8,005	6,458	8,438	7,218
36,900	36,950	8,019	6,472	8,454	7,232
36,950	37,000	8,033	6,486	8,471	7,246
37,000					
37,000	37,050	8,047	6,500	8,487	7,260
37,050	37,100	8,061	6,514	8,504	7,274
37,100	37,150	8,075	6,528	8,520	7,288
37,150	37,200	8,089	6,542	8,537	7,302
37,200	37,250	8,103	6,556	8,553	7,316
37,250	37,300	8,117	6,570	8,570	7,330
37,300	37,350	8,131	6,584	8,586	7,344
37,350	37,400	8,145	6,598	8,603	7,358
37,400	37,450	8,159	6,612	8,619	7,372
37,450	37,500	8,173	6,626	8,636	7,386
37,500	37,550	8,187	6,640	8,652	7,400
37,550	37,600	8,201	6,654	8,669	7,414
37,600	37,650	8,215	6,668	8,685	7,428
37,650	37,700	8,229	6,682	8,702	7,442
37,700	37,750	8,243	6,696	8,718	7,456
37,750	37,800	8,257	6,710	8,735	7,470
37,800	37,850	8,271	6,724	8,751	7,484
37,850	37,900	8,285	6,738	8,768	7,498
37,900	37,950	8,299	6,752	8,784	7,512
37,950	38,000	8,313	6,766	8,801	7,526

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
38,000					
38,000	38,050	8,327	6,780	8,817	7,540
38,050	38,100	8,341	6,794	8,834	7,554
38,100	38,150	8,355	6,808	8,850	7,568
38,150	38,200	8,369	6,822	8,867	7,582
38,200	38,250	8,383	6,836	8,883	7,596
38,250	38,300	8,397	6,850	8,900	7,610
38,300	38,350	8,411	6,864	8,916	7,624
38,350	38,400	8,425	6,878	8,933	7,638
38,400	38,450	8,439	6,892	8,949	7,652
38,450	38,500	8,453	6,906	8,966	7,666
38,500	38,550	8,467	6,920	8,982	7,680
38,550	38,600	8,481	6,934	8,999	7,694
38,600	38,650	8,495	6,948	9,015	7,708
38,650	38,700	8,509	6,962	9,032	7,722
38,700	38,750	8,523	6,976	9,048	7,736
38,750	38,800	8,537	6,990	9,065	7,750
38,800	38,850	8,551	7,004	9,081	7,764
38,850	38,900	8,565	7,018	9,098	7,778
38,900	38,950	8,579	7,032	9,114	7,792
38,950	39,000	8,593	7,046	9,131	7,806
39,000					
39,000	39,050	8,607	7,060	9,147	7,820
39,050	39,100	8,621	7,074	9,164	7,834
39,100	39,150	8,635	7,088	9,180	7,848
39,150	39,200	8,649	7,102	9,197	7,862
39,200	39,250	8,663	7,116	9,213	7,876
39,250	39,300	8,677	7,130	9,230	7,890
39,300	39,350	8,691	7,144	9,246	7,904
39,350	39,400	8,705	7,158	9,263	7,918
39,400	39,450	8,719	7,172	9,279	7,932
39,450	39,500	8,733	7,186	9,296	7,946
39,500	39,550	8,747	7,200	9,312	7,960
39,550	39,600	8,761	7,214	9,329	7,974
39,600	39,650	8,775	7,228	9,345	7,988
39,650	39,700	8,789	7,242	9,362	8,002
39,700	39,750	8,803	7,256	9,378	8,016
39,750	39,800	8,817	7,270	9,395	8,030
39,800	39,850	8,831	7,284	9,411	8,044
39,850	39,900	8,845	7,298	9,428	8,058
39,900	39,950	8,859	7,312	9,444	8,072
39,950	40,000	8,873	7,326	9,461	8,086
40,000					
40,000	40,050	8,887	7,340	9,477	8,100
40,050	40,100	8,901	7,354	9,494	8,114
40,100	40,150	8,915	7,368	9,510	8,128
40,150	40,200	8,929	7,382	9,527	8,142
40,200	40,250	8,943	7,396	9,543	8,156
40,250	40,300	8,957	7,410	9,560	8,170
40,300	40,350	8,971	7,424	9,576	8,184
40,350	40,400	8,985	7,438	9,593	8,198
40,400	40,450	8,999	7,452	9,609	8,212
40,450	40,500	9,013	7,466	9,626	8,226
40,500	40,550	9,027	7,480	9,642	8,240
40,550	40,600	9,041	7,494	9,659	8,254
40,600	40,650	9,055	7,508	9,675	8,268
40,650	40,700	9,069	7,522	9,692	8,282
40,700	40,750	9,083	7,536	9,708	8,296
40,750	40,800	9,097	7,550	9,725	8,310
40,800	40,850	9,111	7,564	9,741	8,324
40,850	40,900	9,125	7,578	9,758	8,338
40,900	40,950	9,139	7,592	9,774	8,352
40,950	41,000	9,153	7,606	9,791	8,366

* This column must also be used by a qualifying widow(er).

Continued on next page

1988 Tax Table—*Continued*

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
41,000					
41,000	**41,050**	9,167	7,620	9,807	8,380
41,050	**41,100**	9,181	7,634	9,824	8,394
41,100	**41,150**	9,195	7,648	9,840	8,408
41,150	**41,200**	9,209	7,662	9,857	8,422
41,200	**41,250**	9,223	7,676	9,873	8,436
41,250	**41,300**	9,237	7,690	9,890	8,450
41,300	**41,350**	9,251	7,704	9,906	8,464
41,350	**41,400**	9,265	7,718	9,923	8,478
41,400	**41,450**	9,279	7,732	9,939	8,492
41,450	**41,500**	9,293	7,746	9,956	8,506
41,500	**41,550**	9,307	7,760	9,972	8,520
41,550	**41,600**	9,321	7,774	9,989	8,534
41,600	**41,650**	9,335	7,788	10,005	8,548
41,650	**41,700**	9,349	7,802	10,022	8,562
41,700	**41,750**	9,363	7,816	10,038	8,576
41,750	**41,800**	9,377	7,830	10,055	8,590
41,800	**41,850**	9,391	7,844	10,071	8,604
41,850	**41,900**	9,405	7,858	10,088	8,618
41,900	**41,950**	9,419	7,872	10,104	8,632
41,950	**42,000**	9,433	7,886	10,121	8,646
42,000					
42,000	**42,050**	9,447	7,900	10,137	8,660
42,050	**42,100**	9,461	7,914	10,154	8,674
42,100	**42,150**	9,475	7,928	10,170	8,688
42,150	**42,200**	9,489	7,942	10,187	8,702
42,200	**42,250**	9,503	7,956	10,203	8,716
42,250	**42,300**	9,517	7,970	10,220	8,730
42,300	**42,350**	9,531	7,984	10,236	8,744
42,350	**42,400**	9,545	7,998	10,253	8,758
42,400	**42,450**	9,559	8,012	10,269	8,772
42,450	**42,500**	9,573	8,026	10,286	8,786
42,500	**42,550**	9,587	8,040	10,302	8,800
42,550	**42,600**	9,601	8,054	10,319	8,814
42,600	**42,650**	9,615	8,068	10,335	8,828
42,650	**42,700**	9,629	8,082	10,352	8,842
42,700	**42,750**	9,643	8,096	10,368	8,856
42,750	**42,800**	9,657	8,110	10,385	8,870
42,800	**42,850**	9,671	8,124	10,401	8,884
42,850	**42,900**	9,685	8,138	10,418	8,898
42,900	**42,950**	9,699	8,152	10,434	8,912
42,950	**43,000**	9,713	8,166	10,451	8,926
43,000					
43,000	**43,050**	9,727	8,180	10,467	8,940
43,050	**43,100**	9,741	8,194	10,484	8,954
43,100	**43,150**	9,755	8,208	10,500	8,968
43,150	**43,200**	9,770	8,222	10,517	8,982
43,200	**43,250**	9,786	8,236	10,533	8,996
43,250	**43,300**	9,803	8,250	10,550	9,010
43,300	**43,350**	9,819	8,264	10,566	9,024
43,350	**43,400**	9,836	8,278	10,583	9,038
43,400	**43,450**	9,852	8,292	10,599	9,052
43,450	**43,500**	9,869	8,306	10,616	9,066
43,500	**43,550**	9,885	8,320	10,632	9,080
43,550	**43,600**	9,902	8,334	10,649	9,094
43,600	**43,650**	9,918	8,348	10,665	9,108
43,650	**43,700**	9,935	8,362	10,682	9,122
43,700	**43,750**	9,951	8,376	10,698	9,136
43,750	**43,800**	9,968	8,390	10,715	9,150
43,800	**43,850**	9,984	8,404	10,731	9,164
43,850	**43,900**	10,001	8,418	10,748	9,178
43,900	**43,950**	10,017	8,432	10,764	9,192
43,950	**44,000**	10,034	8,446	10,781	9,206

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
44,000					
44,000	**44,050**	10,050	8,460	10,797	9,220
44,050	**44,100**	10,067	8,474	10,814	9,234
44,100	**44,150**	10,083	8,488	10,830	9,248
44,150	**44,200**	10,100	8,502	10,847	9,262
44,200	**44,250**	10,116	8,516	10,863	9,276
44,250	**44,300**	10,133	8,530	10,880	9,290
44,300	**44,350**	10,149	8,544	10,896	9,304
44,350	**44,400**	10,166	8,558	10,913	9,318
44,400	**44,450**	10,182	8,572	10,929	9,332
44,450	**44,500**	10,199	8,586	10,946	9,346
44,500	**44,550**	10,215	8,600	10,962	9,360
44,550	**44,600**	10,232	8,614	10,979	9,374
44,600	**44,650**	10,248	8,628	10,995	9,388
44,650	**44,700**	10,265	8,642	11,012	9,402
44,700	**44,750**	10,281	8,656	11,028	9,416
44,750	**44,800**	10,298	8,670	11,045	9,430
44,800	**44,850**	10,314	8,684	11,061	9,444
44,850	**44,900**	10,331	8,698	11,078	9,458
44,900	**44,950**	10,347	8,712	11,094	9,472
44,950	**45,000**	10,364	8,726	11,111	9,486
45,000					
45,000	**45,050**	10,380	8,740	11,127	9,500
45,050	**45,100**	10,397	8,754	11,144	9,514
45,100	**45,150**	10,413	8,768	11,160	9,528
45,150	**45,200**	10,430	8,782	11,177	9,542
45,200	**45,250**	10,446	8,796	11,193	9,556
45,250	**45,300**	10,463	8,810	11,210	9,570
45,300	**45,350**	10,479	8,824	11,226	9,584
45,350	**45,400**	10,496	8,838	11,243	9,598
45,400	**45,450**	10,512	8,852	11,259	9,612
45,450	**45,500**	10,529	8,866	11,276	9,626
45,500	**45,550**	10,545	8,880	11,292	9,640
45,550	**45,600**	10,562	8,894	11,309	9,654
45,600	**45,650**	10,578	8,908	11,325	9,668
45,650	**45,700**	10,595	8,922	11,342	9,682
45,700	**45,750**	10,611	8,936	11,358	9,696
45,750	**45,800**	10,628	8,950	11,375	9,710
45,800	**45,850**	10,644	8,964	11,391	9,724
45,850	**45,900**	10,661	8,978	11,408	9,738
45,900	**45,950**	10,677	8,992	11,424	9,752
45,950	**46,000**	10,694	9,006	11,441	9,766
46,000					
46,000	**46,050**	10,710	9,020	11,457	9,780
46,050	**46,100**	10,727	9,034	11,474	9,794
46,100	**46,150**	10,743	9,048	11,490	9,808
46,150	**46,200**	10,760	9,062	11,507	9,822
46,200	**46,250**	10,776	9,076	11,523	9,836
46,250	**46,300**	10,793	9,090	11,540	9,850
46,300	**46,350**	10,809	9,104	11,556	9,864
46,350	**46,400**	10,826	9,118	11,573	9,878
46,400	**46,450**	10,842	9,132	11,589	9,892
46,450	**46,500**	10,859	9,146	11,606	9,906
46,500	**46,550**	10,875	9,160	11,622	9,920
46,550	**46,600**	10,892	9,174	11,639	9,934
46,600	**46,650**	10,908	9,188	11,655	9,948
46,650	**46,700**	10,925	9,202	11,672	9,962
46,700	**46,750**	10,941	9,216	11,688	9,976
46,750	**46,800**	10,958	9,230	11,705	9,990
46,800	**46,850**	10,974	9,244	11,721	10,004
46,850	**46,900**	10,991	9,258	11,738	10,018
46,900	**46,950**	11,007	9,272	11,754	10,032
46,950	**47,000**	11,024	9,286	11,771	10,046

If line 7 (1040EZ), line 19 (1040A), or line 37 (1040) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
47,000					
47,000	**47,050**	11,040	9,300	11,787	10,060
47,050	**47,100**	11,057	9,314	11,804	10,074
47,100	**47,150**	11,073	9,328	11,820	10,088
47,150	**47,200**	11,090	9,342	11,837	10,102
47,200	**47,250**	11,106	9,356	11,853	10,116
47,250	**47,300**	11,123	9,370	11,870	10,130
47,300	**47,350**	11,139	9,384	11,886	10,144
47,350	**47,400**	11,156	9,398	11,903	10,158
47,400	**47,450**	11,172	9,412	11,919	10,172
47,450	**47,500**	11,189	9,426	11,936	10,186
47,500	**47,550**	11,205	9,440	11,952	10,200
47,550	**47,600**	11,222	9,454	11,969	10,214
47,600	**47,650**	11,238	9,468	11,985	10,228
47,650	**47,700**	11,255	9,482	12,002	10,242
47,700	**47,750**	11,271	9,496	12,018	10,256
47,750	**47,800**	11,288	9,510	12,035	10,270
47,800	**47,850**	11,304	9,524	12,051	10,284
47,850	**47,900**	11,321	9,538	12,068	10,298
47,900	**47,950**	11,337	9,552	12,084	10,312
47,950	**48,000**	11,354	9,566	12,101	10,326
48,000					
48,000	**48,050**	11,370	9,580	12,117	10,340
48,050	**48,100**	11,387	9,594	12,134	10,354
48,100	**48,150**	11,403	9,608	12,150	10,368
48,150	**48,200**	11,420	9,622	12,167	10,382
48,200	**48,250**	11,436	9,636	12,183	10,396
48,250	**48,300**	11,453	9,650	12,200	10,410
48,300	**48,350**	11,469	9,664	12,216	10,424
48,350	**48,400**	11,486	9,678	12,233	10,438
48,400	**48,450**	11,502	9,692	12,249	10,452
48,450	**48,500**	11,519	9,706	12,266	10,466
48,500	**48,550**	11,535	9,720	12,282	10,480
48,550	**48,600**	11,552	9,734	12,299	10,494
48,600	**48,650**	11,568	9,748	12,315	10,508
48,650	**48,700**	11,585	9,762	12,332	10,522
48,700	**48,750**	11,601	9,776	12,348	10,536
48,750	**48,800**	11,618	9,790	12,365	10,550
48,800	**48,850**	11,634	9,804	12,381	10,564
48,850	**48,900**	11,651	9,818	12,398	10,578
48,900	**48,950**	11,667	9,832	12,414	10,592
48,950	**49,000**	11,684	9,846	12,431	10,606
49,000					
49,000	**49,050**	11,700	9,860	12,447	10,620
49,050	**49,100**	11,717	9,874	12,464	10,634
49,100	**49,150**	11,733	9,888	12,480	10,648
49,150	**49,200**	11,750	9,902	12,497	10,662
49,200	**49,250**	11,766	9,916	12,513	10,676
49,250	**49,300**	11,783	9,930	12,530	10,690
49,300	**49,350**	11,799	9,944	12,546	10,704
49,350	**49,400**	11,816	9,958	12,563	10,718
49,400	**49,450**	11,832	9,972	12,579	10,732
49,450	**49,500**	11,849	9,986	12,596	10,746
49,500	**49,550**	11,865	10,000	12,612	10,760
49,550	**49,600**	11,882	10,014	12,629	10,774
49,600	**49,650**	11,898	10,028	12,645	10,788
49,650	**49,700**	11,915	10,042	12,662	10,802
49,700	**49,750**	11,931	10,056	12,678	10,816
49,750	**49,800**	11,948	10,070	12,695	10,830
49,800	**49,850**	11,964	10,084	12,711	10,844
49,850	**49,900**	11,981	10,098	12,728	10,858
49,900	**49,950**	11,997	10,112	12,744	10,872
49,950	**50,000**	12,014	10,126	12,761	10,886

50,000 or over—use tax rate schedules

* This column must also be used by a qualifying widow(er).

1988 Tax Rate Schedules

Caution: *Use ONLY if your taxable income (Form 1040, line 37) is $50,000 or more. If less, use the* ***Tax Table.***

Schedule X—Use if your filing status is Single

If the amount on Form 1040, line 37, is: *Over—*	*But not over—*	Enter on Form 1040, line 38	*of the amount over—*
$0	$17,850	.......**15%**	**$0**
17,850	43,150	**$2,677.50 + 28%**	**17,850**
43,150	89,560	**9,761.50 + 33%**	**43,150**
89,560	....	Use **Worksheet** below to figure your tax.	

Schedule Z—Use if your filing status is Head of household

If the amount on Form 1040, line 37, is: *Over—*	*But not over—*	Enter on Form 1040, line 38	*of the amount over—*
$0	$23,900	.......**15%**	**$0**
23,900	61,650	**$3,585 + 28%**	**23,900**
61,650	123,790	**14,155 + 33%**	**61,650**
123,790	....	Use **Worksheet** below to figure your tax.	

Schedule Y-1—Use if your filing status is Married filing jointly or Qualifying widow(er)

If the amount on Form 1040, line 37, is: *Over—*	*But not over—*	Enter on Form 1040, line 38	*of the amount over—*
$0	$29,750	.......**15%**	**$0**
29,750	71,900	**$4,462.50 + 28%**	**29,750**
71,900	149,250	**16,264.50 + 33%**	**71,900**
149,250	....	Use **Worksheet** below to figure your tax.	

Schedule Y-2—Use if your filing status is Married filing separately

If the amount on Form 1040, line 37, is: *Over—*	*But not over—*	Enter on Form 1040, line 38	*of the amount over—*
$0	$14,875	.......**15%**	**$0**
14,875	35,950	**$2,231.25 + 28%**	**14,875**
35,950	113,300	**8,132.25 + 33%**	**35,950**
113,300	....	Use **Worksheet** below to figure your tax.	

Worksheet (Keep for your records)

1. If your filing status is:
- Single, enter $25,076.80
- Head of household, enter $34,661.20
- Married filing jointly or Qualifying widow(er), enter $41,790.00
- Married filing separately, enter $33,657.75

. . . . **1.** ______________

2. Enter your taxable income from Form 1040, line 37 . . . . **2.** ______________

3. If your filing status is:
- Single, enter $89,560
- Head of household, enter $123,790
- Married filing jointly or Qualifying widow(er), enter $149,250
- Married filing separately, enter $113,300

. . . . . **3.** ______________

4. Subtract line 3 from line 2. Enter the result. (If the result is zero or less, use the schedule above for your filing status to figure your tax. DO NOT use this worksheet.) **4.** ______________

5. Multiply the amount on line 4 by 28% (.28). Enter the result . . . . **5.** ______________

6. Multiply the amount on line 4 by 5% (.05). Enter the result . . . . **6.** ______________

7. Multiply $546 by the number of exemptions claimed on Form 1040, line 6e. (If married filing separately, see the **Caution** below.) Enter the result . . . . **7.** ______________

8. Compare the amounts on lines 6 and 7. Enter the **smaller** of the two amounts . . . . **8.** ______________

9. **Tax.** Add lines 1, 5, and 8. Enter the total here and on Form 1040, line 38 . . . . **9.** ______________

Caution: *Recent legislation will require married persons filing separately who did* ***not*** *claim an exemption for their spouse to add $546 to the result otherwise figured on line 7 above. Get* ***Pub. 553,*** *Highlights of 1988 Tax Changes, for more information on this new law.*

1988 Earned Income Credit Table

Caution: *This Is Not a Tax Table*

To find your earned income credit: Read down the column titled "If the amount on the worksheet is—" and find the appropriate amount from the Earned Income Credit Worksheet. Read across to the right and find the amount of the income credit. Enter that amount on the appropriate line of the worksheet.

If the amount on the worksheet is—		Your earned income credit is—	If the amount on the worksheet is—		Your earned income credit is—	If the amount on the worksheet is—		Your earned income credit is—	If the amount on the worksheet is—		Your earned income credit is—	If the amount on the worksheet is—		Your earned income credit is—
At least	But less than		At least	But less than		At least	But less than		At least	But less than		At least	But less than	
$1	$25	$2	$1,600	$1,625	$226	$3,200	$3,225	$450	$4,800	$4,825	$674	$10,000	$10,025	$857
25	50	5	1,625	1,650	229	3,225	3,250	453	4,825	4,850	677	10,025	10,050	854
50	75	9	1,650	1,675	233	3,250	3,275	457	4,850	4,875	681	10,050	10,075	852
75	100	12	1,675	1,700	236	3,275	3,300	460	4,875	4,900	684	10,075	10,100	849
100	125	16	1,700	1,725	240	3,300	3,325	464	4,900	4,925	688	10,100	10,125	847
125	150	19	1,725	1,750	243	3,325	3,350	467	4,925	4,950	691	10,125	10,150	844
150	175	23	1,750	1,775	247	3,350	3,375	471	4,950	4,975	695	10,150	10,175	842
175	200	26	1,775	1,800	250	3,375	3,400	474	4,975	5,000	698	10,175	10,200	839
200	225	30	1,800	1,825	254	3,400	3,425	478	5,000	5,025	702	10,200	10,225	837
225	250	33	1,825	1,850	257	3,425	3,450	481	5,025	5,050	705	10,225	10,250	834
250	275	37	1,850	1,875	261	3,450	3,475	485	5,050	5,075	709	10,250	10,275	832
275	300	40	1,875	1,900	264	3,475	3,500	488	5,075	5,100	712	10,275	10,300	829
300	325	44	1,900	1,925	268	3,500	3,525	492	5,100	5,125	716	10,300	10,325	827
325	350	47	1,925	1,950	271	3,525	3,550	495	5,125	5,150	719	10,325	10,350	824
350	375	51	1,950	1,975	275	3,550	3,575	499	5,150	5,175	723	10,350	10,375	822
375	400	54	1,975	2,000	278	3,575	3,600	502	5,175	5,200	726	10,375	10,400	819
400	425	58	2,000	2,025	282	3,600	3,625	506	5,200	5,225	730	10,400	10,425	817
425	450	61	2,025	2,050	285	3,625	3,650	509	5,225	5,250	733	10,425	10,450	814
450	475	65	2,050	2,075	289	3,650	3,675	513	5,250	5,275	737	10,450	10,475	812
475	500	68	2,075	2,100	292	3,675	3,700	516	5,275	5,300	740	10,475	10,500	809
500	525	72	2,100	2,125	296	3,700	3,725	520	5,300	5,325	744	10,500	10,525	807
525	550	75	2,125	2,150	299	3,725	3,750	523	5,325	5,350	747	10,525	10,550	804
550	575	79	2,150	2,175	303	3,750	3,775	527	5,350	5,375	751	10,550	10,575	802
575	600	82	2,175	2,200	306	3,775	3,800	530	5,375	5,400	754	10,575	10,600	799
600	625	86	2,200	2,225	310	3,800	3,825	534	5,400	5,425	758	10,600	10,625	797
625	650	89	2,225	2,250	313	3,825	3,850	537	5,425	5,450	761	10,625	10,650	794
650	675	93	2,250	2,275	317	3,850	3,875	541	5,450	5,475	765	10,650	10,675	792
675	700	96	2,275	2,300	320	3,875	3,900	544	5,475	5,500	768	10,675	10,700	789
700	725	100	2,300	2,325	324	3,900	3,925	548	5,500	5,525	772	10,700	10,725	787
725	750	103	2,325	2,350	327	3,925	3,950	551	5,525	5,550	775	10,725	10,750	784
750	775	107	2,350	2,375	331	3,950	3,975	555	5,550	5,575	779	10,750	10,775	782
775	800	110	2,375	2,400	334	3,975	4,000	558	5,575	5,600	782	10,775	10,800	779
800	825	114	2,400	2,425	338	4,000	4,025	562	5,600	5,625	786	10,800	10,825	777
825	850	117	2,425	2,450	341	4,025	4,050	565	5,625	5,650	789	10,825	10,850	774
850	875	121	2,450	2,475	345	4,050	4,075	569	5,650	5,675	793	10,850	10,875	772
875	900	124	2,475	2,500	348	4,075	4,100	572	5,675	5,700	796	10,875	10,900	769
900	925	128	2,500	2,525	352	4,100	4,125	576	5,700	5,725	800	10,900	10,925	767
925	950	131	2,525	2,550	355	4,125	4,150	579	5,725	5,750	803	10,925	10,950	764
950	975	135	2,550	2,575	359	4,150	4,175	583	5,750	5,775	807	10,950	10,975	762
975	1,000	138	2,575	2,600	362	4,175	4,200	586	5,775	5,800	810	10,975	11,000	759
1,000	1,025	142	2,600	2,625	366	4,200	4,225	590	5,800	5,825	814	11,000	11,025	757
1,025	1,050	145	2,625	2,650	369	4,225	4,250	593	5,825	5,850	817	11,025	11,050	754
1,050	1,075	149	2,650	2,675	373	4,250	4,275	597	5,850	5,875	821	11,050	11,075	752
1,075	1,100	152	2,675	2,700	376	4,275	4,300	600	5,875	5,900	824	11,075	11,100	749
1,100	1,125	156	2,700	2,725	380	4,300	4,325	604	5,900	5,925	828	11,100	11,125	747
1,125	1,150	159	2,725	2,750	383	4,325	4,350	607	5,925	5,950	831	11,125	11,150	744
1,150	1,175	163	2,750	2,775	387	4,350	4,375	611	5,950	5,975	835	11,150	11,175	742
1,175	1,200	166	2,775	2,800	390	4,375	4,400	614	5,975	6,000	838	11,175	11,200	739
1,200	1,225	170	2,800	2,825	394	4,400	4,425	618	6,000	6,025	842	11,200	11,225	737
1,225	1,250	173	2,825	2,850	397	4,425	4,450	621	6,025	6,050	845	11,225	11,250	734
1,250	1,275	177	2,850	2,875	401	4,450	4,475	625	6,050	6,075	849	11,250	11,275	732
1,275	1,300	180	2,875	2,900	404	4,475	4,500	628	6,075	6,100	852	11,275	11,300	729
1,300	1,325	184	2,900	2,925	408	4,500	4,525	632	6,100	6,125	856	11,300	11,325	727
1,325	1,350	187	2,925	2,950	411	4,525	4,550	635	6,125	6,150	859	11,325	11,350	724
1,350	1,375	191	2,950	2,975	415	4,550	4,575	639	6,150	6,175	863	11,350	11,375	722
1,375	1,400	194	2,975	3,000	418	4,575	4,600	642	6,175	6,200	866	11,375	11,400	719
1,400	1,425	198	3,000	3,025	422	4,600	4,625	646	6,200	6,225	870	11,400	11,425	717
1,425	1,450	201	3,025	3,050	425	4,625	4,650	649	6,225	9,850	874	11,425	11,450	714
1,450	1,475	205	3,050	3,075	429	4,650	4,675	653	9,850	9,875	872	11,450	11,475	712
1,475	1,500	208	3,075	3,100	432	4,675	4,700	656	9,875	9,900	869	11,475	11,500	709
1,500	1,525	212	3,100	3,125	436	4,700	4,725	660	9,900	9,925	867	11,500	11,525	707
1,525	1,550	215	3,125	3,150	439	4,725	4,750	663	9,925	9,950	864	11,525	11,550	704
1,550	1,575	219	3,150	3,175	443	4,750	4,775	667	9,950	9,975	862	11,550	11,575	702
1,575	1,600	222	3,175	3,200	446	4,775	4,800	670	9,975	10,000	859	11,575	11,600	699

1988 Earned Income Credit Table *(Continued)*

If the amount on the worksheet is—		Your earned income credit is—	If the amount on the worksheet is—		Your earned income credit is—	If the amount on the worksheet is—		Your earned income credit is—	If the amount on the worksheet is—		Your earned income credit is—	If the amount on the worksheet is—		Your earned income credit is—
At least	But less than		At least	But less than		At least	But less than		At least	But less than		At least	But less than	
$11,600	$11,625	$697	$13,000	$13,025	$557	$14,400	$14,425	$417	$15,800	$15,825	$277	$17,200	$17,225	$137
11,625	11,650	694	13,025	13,050	554	14,425	14,450	414	15,825	15,850	274	17,225	17,250	134
11,650	11,675	692	13,050	13,075	552	14,450	14,475	412	15,850	15,875	272	17,250	17,275	132
11,675	11,700	689	13,075	13,100	549	14,475	14,500	409	15,875	15,900	269	17,275	17,300	129
11,700	11,725	687	13,100	13,125	547	14,500	14,525	407	15,900	15,925	267	17,300	17,325	127
11,725	11,750	684	13,125	13,150	544	14,525	14,550	404	15,925	15,950	264	17,325	17,350	124
11,750	11,775	682	13,150	13,175	542	14,550	14,575	402	15,950	15,975	262	17,350	17,375	122
11,775	11,800	679	13,175	13,200	539	14,575	14,600	399	15,975	16,000	259	17,375	17,400	119
11,800	11,825	677	13,200	13,225	537	14,600	14,625	397	16,000	16,025	257	17,400	17,425	117
11,825	11,850	674	13,225	13,250	534	14,625	14,650	394	16,025	16,050	254	17,425	17,450	114
11,850	11,875	672	13,250	13,275	532	14,650	14,675	392	16,050	16,075	252	17,450	17,475	112
11,875	11,900	669	13,275	13,300	529	14,675	14,700	389	16,075	16,100	249	17,475	17,500	109
11,900	11,925	667	13,300	13,325	527	14,700	14,725	387	16,100	16,125	247	17,500	17,525	107
11,925	11,950	664	13,325	13,350	524	14,725	14,750	384	16,125	16,150	244	17,525	17,550	104
11,950	11,975	662	13,350	13,375	522	14,750	14,775	382	16,150	16,175	242	17,550	17,575	102
11,975	12,000	659	13,375	13,400	519	14,775	14,800	379	16,175	16,200	239	17,575	17,600	99
12,000	12,025	657	13,400	13,425	517	14,800	14,825	377	16,200	16,225	237	17,600	17,625	97
12,025	12,050	654	13,425	13,450	514	14,825	14,850	374	16,225	16,250	234	17,625	17,650	94
12,050	12,075	652	13,450	13,475	512	14,850	14,875	372	16,250	16,275	232	17,650	17,675	92
12,075	12,100	649	13,475	13,500	509	14,875	14,900	369	16,275	16,300	229	17,675	17,700	89
12,100	12,125	647	13,500	13,525	507	14,900	14,925	367	16,300	16,325	227	17,700	17,725	87
12,125	12,150	644	13,525	13,550	504	14,925	14,950	364	16,325	16,350	224	17,725	17,750	84
12,150	12,175	642	13,550	13,575	502	14,950	14,975	362	16,350	16,375	222	17,750	17,775	82
12,175	12,200	639	13,575	13,600	499	14,975	15,000	359	16,375	16,400	219	17,775	17,800	79
12,200	12,225	637	13,600	13,625	497	15,000	15,025	357	16,400	16,425	217	17,800	17,825	77
12,225	12,250	634	13,625	13,650	494	15,025	15,050	354	16,425	16,450	214	17,825	17,850	74
12,250	12,275	632	13,650	13,675	492	15,050	15,075	352	16,450	16,475	212	17,850	17,875	72
12,275	12,300	629	13,675	13,700	489	15,075	15,100	349	16,475	16,500	209	17,875	17,900	69
12,300	12,325	627	13,700	13,725	487	15,100	15,125	347	16,500	16,525	207	17,900	17,925	67
12,325	12,350	624	13,725	13,750	484	15,125	15,150	344	16,525	16,550	204	17,925	17,950	64
12,350	12,375	622	13,750	13,775	482	15,150	15,175	342	16,550	16,575	202	17,950	17,975	62
12,375	12,400	619	13,775	13,800	479	15,175	15,200	339	16,575	16,600	199	17,975	18,000	59
12,400	12,425	617	13,800	13,825	477	15,200	15,225	337	16,600	16,625	197	18,000	18,025	57
12,425	12,450	614	13,825	13,850	474	15,225	15,250	334	16,625	16,650	194	18,025	18,050	54
12,450	12,475	612	13,850	13,875	472	15,250	15,275	332	16,650	16,675	192	18,050	18,075	52
12,475	12,500	609	13,875	13,900	469	15,275	15,300	329	16,675	16,700	189	18,075	18,100	49
12,500	12,525	607	13,900	13,925	467	15,300	15,325	327	16,700	16,725	187	18,100	18,125	47
12,525	12,550	604	13,925	13,950	464	15,325	15,350	324	16,725	16,750	184	18,125	18,150	44
12,550	12,575	602	13,950	13,975	462	15,350	15,375	322	16,750	16,775	182	18,150	18,175	42
12,575	12,600	599	13,975	14,000	459	15,375	15,400	319	16,775	16,800	179	18,175	18,200	39
12,600	12,625	597	14,000	14,025	457	15,400	15,425	317	16,800	16,825	177	18,200	18,225	37
12,625	12,650	594	14,025	14,050	454	15,425	15,450	314	16,825	16,850	174	18,225	18,250	34
12,650	12,675	592	14,050	14,075	452	15,450	15,475	312	16,850	16,875	172	18,250	18,275	32
12,675	12,700	589	14,075	14,100	449	15,475	15,500	309	16,875	16,900	169	18,275	18,300	29
12,700	12,725	587	14,100	14,125	447	15,500	15,525	307	16,900	16,925	167	18,300	18,325	27
12,725	12,750	584	14,125	14,150	444	15,525	15,550	304	16,925	16,950	164	18,325	18,350	24
12,750	12,775	582	14,150	14,175	442	15,550	15,575	302	16,950	16,975	162	18,350	18,375	22
12,775	12,800	579	14,175	14,200	439	15,575	15,600	299	16,975	17,000	159	18,375	18,400	19
12,800	12,825	577	14,200	14,225	437	15,600	15,625	297	17,000	17,025	157	18,400	18,425	17
12,825	12,850	574	14,225	14,250	434	15,625	15,650	294	17,025	17,050	154	18,425	18,450	14
12,850	12,875	572	14,250	14,275	432	15,650	15,675	292	17,050	17,075	152	18,450	18,475	12
12,875	12,900	569	14,275	14,300	429	15,675	15,700	289	17,075	17,100	149	18,475	18,500	9
12,900	12,925	567	14,300	14,325	427	15,700	15,725	287	17,100	17,125	147	18,500	18,525	7
12,925	12,950	564	14,325	14,350	424	15,725	15,750	284	17,125	17,150	144	18,525	18,550	4
12,950	12,975	562	14,350	14,375	422	15,750	15,775	282	17,150	17,175	142	18,550	18,575	2
12,975	13,000	559	14,375	14,400	419	15,775	15,800	279	17,175	17,200	139	18,575	18,576	1

$18,576 or more—you cannot take the credit

Call IRS With Your Tax Question

If the instructions to the tax forms and our free tax publications have not answered your question, please call us TOLL-FREE. "Toll-Free" is a telephone call for which you pay only local charges.

CHOOSING THE RIGHT NUMBER: Use only the number listed below for your area. Use a local city number only if it is not a long distance call for you. **Please do not dial 1-800 when using a local city number.**

BEFORE YOU CALL: Remember that good communication is a two-way process. IRS representatives care about the quality of the service we provide to you, our customer. You can help us provide accurate, complete answers to your tax questions by having the following information available:

1. The tax form, schedule, or notice to which your question relates;
2. The facts about your particular situation (the answer to the same question often varies from one taxpayer to another because of differences in their age, income, whether they can be claimed as a dependent, etc.);
3. The name of any IRS publication or other source of information that you used to look for the answer.

BEFORE YOU HANG UP: If you do not fully understand the answer you receive, or you feel our representative may not fully understand your question, our representative needs to know this. He or she will be happy to take the additional time required to be sure we have answered your question fully and in the manner which is most helpful to you.

By law, you are responsible for paying your fair share of Federal income tax. If we should make an error in answering your question, you are still responsible for the payment of the correct tax. Should this occur, however, you will not be charged any penalty. To make sure that IRS representatives give accurate and courteous answers, a second IRS representative sometimes listens in on telephone calls. No record is kept of any taxpayer's identity.

ALABAMA
1-800-424-1040

ALASKA
Anchorage, 561-7484
Elsewhere, 1-800-424-1040

ARIZONA
Phoenix, 257-1233
Elsewhere, 1-800-424-1040

ARKANSAS
1-800-424-1040

CALIFORNIA
Please call the telephone number shown in the white pages of your local telephone directory under U.S. Government, Internal Revenue Service, Federal Tax Assistance.

COLORADO
Denver, 825-7041
Elsewhere, 1-800-424-1040

CONNECTICUT
1-800-424-1040

DELAWARE
1-800-424-1040

DISTRICT of COLUMBIA
488-3100

FLORIDA
Jacksonville, 354-1760
Elsewhere, 1-800-424-1040

GEORGIA
Atlanta, 522-0050
Elsewhere, 1-800-424-1040

HAWAII
Oahu, 541-1040
Elsewhere, 1-800-424-1040

IDAHO
1-800-424-1040

ILLINOIS
Chicago, 435-1040
Elsewhere, 1-800-424-1040

INDIANA
Indianapolis, 226-5477
Elsewhere, 1-800-424-1040

IOWA
Des Moines, 283-0523
Elsewhere, 1-800-424-1040

KANSAS
1-800-424-1040

KENTUCKY
1-800-424-1040

LOUISIANA
1-800-424-1040

MAINE
1-800-424-1040

MARYLAND
Baltimore, 962-2590
Montgomery County, 488-3100
Prince George's County, 488-3100
Elsewhere, 1-800-424-1040

MASSACHUSETTS
Boston, 523-1040
Elsewhere, 1-800-424-1040

MICHIGAN
Detroit, 237-0800
Elsewhere, 1-800-424-1040

MINNESOTA
Minneapolis, 291-1422
St. Paul, 291-1422
Elsewhere, 1-800-424-1040

MISSISSIPPI
1-800-424-1040

MISSOURI
St. Louis, 342-1040
Elsewhere, 1-800-424-1040

MONTANA
1-800-424-1040

NEBRASKA
Omaha, 422-1500
Elsewhere, 1-800-424-1040

NEVADA
1-800-424-1040

NEW HAMPSHIRE
1-800-424-1040

NEW JERSEY
Newark, 622-0600
Elsewhere, 1-800-424-1040

NEW MEXICO
1-800-424-1040

NEW YORK
Bronx, 732-0100
Brooklyn, 596-3770
Buffalo, 855-3955
Manhattan, 732-0100
Nassau, 222-1131
Queens, 596-3770
Rockland County, 997-1510
Staten Island, 596-3770
Suffolk, 724-5000
Westchester County, 997-1510
Elsewhere, 1-800-424-1040

NORTH CAROLINA
1-800-424-1040

NORTH DAKOTA
1-800-424-1040

OHIO
Cincinnati, 621-6281
Cleveland, 522-3000
Elsewhere, 1-800-424-1040

OKLAHOMA
1-800-424-1040

OREGON
Portland, 221-3960
Elsewhere, 1-800-424-1040

PENNSYLVANIA
Philadelphia, 574-9900
Pittsburgh, 281-0112
Elsewhere, 1-800-424-1040

PUERTO RICO
San Juan Metro Area, 766-5040
Isla DDD, 766-5549

RHODE ISLAND
1-800-424-1040

SOUTH CAROLINA
1-800-424-1040

SOUTH DAKOTA
1-800-424-1040

TENNESSEE
Nashville, 259-4601
Elsewhere, 1-800-424-1040

TEXAS
Dallas, 742-2440
Ft. Worth, 263-9229
Houston, 965-0440
Elsewhere, 1-800-424-1040

UTAH
1-800-424-1040

VERMONT
1-800-424-1040

VIRGINIA
Bailey's Crossroads, 557-9230
Richmond, 649-2361
Elsewhere, 1-800-424-1040

WASHINGTON
Seattle, 442-1040
Elsewhere, 1-800-424-1040

WEST VIRGINIA
1-800-424-1040

WISCONSIN
Milwaukee, 271-3780
Elsewhere, 1-800-424-1040

WYOMING
1-800-424-1040

Telephone Assistance Services for Deaf Taxpayers Who Have Access to TV/Telephone—TTY Equipment.

Indiana residents, 1-800-382-4059

Elsewhere in U.S., including Alaska, Hawaii, Virgin Islands, and Puerto Rico, 1-800-428-4732

Hours of Operation

8:00 A.M. to 6:45 P.M. EST (Jan. 1–April 17)

8:00 A.M. to 4:30 P.M. EST (April 18–Dec. 31)

Taxpayers overseas—see *Important Reminders* at the beginning of this publication.

Need Additional Forms or Publications?

If you do not have any tax questions and you only need tax forms and publications, you can—

- Visit your local bank or post office for Forms 1040, 1040A, 1040EZ and Schedules A&B and their related instructions.
- Visit your local library that stocks a wider variety of forms and publications.
- Visit your local IRS office.
- Use the handy order blank later in this publication. You should receive the items you order within 2 weeks of the time you mail your request.
- Call our toll-free "Forms Only" number (1-800-424-FORM (3676)). The hours of operation during the filing season are 8:00 A.M. to 8:00 P.M. (Monday–Friday) and 9:00 A.M. to 3:00 P.M. (Saturdays). You should receive your order within 7 to 10 work days after you call.

What Is Tele-Tax?

Automated Refund Information is available so you can check the status of your refund.

Recorded Tax Information has about 140 topics of tax information that answer many Federal tax questions. You can hear up to three topics on each call you make.

To Call Tele-Tax Toll-Free, Use Only the Numbers Listed Below for Your Area.

Long-distance charges apply if you call from outside the local dialing area of the numbers listed below. **Do not dial 1-800 when using a local number.** A complete list of these topics is on the next page.

How Do I Use Tele-Tax?

Automated Refund Information

1. **Have a copy of your tax return available since you will need to know the first social security number shown on your return, the filing status, and the *exact* amount of your refund.**
2. Call the appropriate phone number listed below.
3. Follow the recorded instructions.
4. • Push-button (tone signaling) service is available Monday through Friday from 7:00 A.M. to 11:30 P.M. (Hours may vary in your area.)
   - Rotary (dial)/push-button (pulse dial) service is available Monday through Friday during regular office hours. (In Hawaii, from 6:30 A.M. to 1:00 P.M.)

Recorded Tax Information

1. Select, by number, the topic you want to hear.
2. Have paper and pencil handy to take notes.
3. Call the appropriate phone number listed below.
4. • If you have a push-button (tone signaling) phone, immediately follow the recorded instructions, or
   - If you have a rotary (dial) or push-button (pulse dial) phone, wait for further recorded instructions.
5. • Push-button (tone signaling) service is available 24 hours a day, 7 days a week.
   - Rotary (dial)/push-button (pulse dial) service is available Monday through Friday during regular office hours. (In Hawaii, from 6:30 A.M. to 1:00 P.M.)

ALABAMA
1-800-554-4477

ALASKA
1-800-554-4477

ARIZONA
Phoenix, 252-4909
Elsewhere,
1-800-554-4477

ARKANSAS
1-800-554-4477

CALIFORNIA
Counties of Amador, Calaveras, Contra Costa, Marin, and San Joaquin,
1-800-428-4032
Los Angeles, 617-3177
Oakland, 839-4245
Elsewhere,
1-800-554-4477

COLORADO
Denver, 592-1118
Elsewhere,
1-800-554-4477

CONNECTICUT
1-800-554-4477

DELAWARE
1-800–554-4477

DISTRICT of COLUMBIA
628-2929

FLORIDA
Jacksonville, 353-9579
Elsewhere,
1-800-554-4477

GEORGIA
Atlanta, 331-6572
Elsewhere,
1-800-554-4477

HAWAII
1-800-554-4477

IDAHO
1-800-554-4477

ILLINOIS
Chicago, 829-6397
Springfield, 789-0489
Elsewhere,
1-800-554-4477

INDIANA
Indianapolis, 631-1010
Elsewhere,
1-800-554-4477

IOWA
1-800-554-4477

KANSAS
1-800-554-4477

KENTUCKY
1-800-554-4477

LOUISIANA
1-800-554-4477

MAINE
1-800-554-4477

MARYLAND
Baltimore, 244-7306
Elsewhere,
1-800-554-4477

MASSACHUSETTS
Boston, 523-8602
Elsewhere,
1-800-554-4477

MICHIGAN
Detroit, 961-4282
Elsewhere,
1-800-554-4477

MINNESOTA
St. Paul, 224-4288
Elsewhere,
1-800-554-4477

MISSISSIPPI
1-800-554-4477

MISSOURI
St. Louis, 241-4700
Elsewhere,
1-800-554-4477

MONTANA
1-800-554-4477

NEBRASKA
Omaha, 221-3324
Elsewhere,
1-800-554-4477

NEVADA
1-800-554-4477

NEW HAMPSHIRE
1-800-554-4477

NEW JERSEY
Newark, 624-1223
Elsewhere,
1-800-554-4477

NEW MEXICO
1-800-554-4477

NEW YORK
Brooklyn, 858-4461
Buffalo, 856-9320
Manhattan, 406-4080
Queens, 858-4461
Staten Island,
858-4461
Elsewhere,
1-800-554-4477

NORTH CAROLINA
1-800-554-4477

NORTH DAKOTA
1-800-554-4477

OHIO
Cincinnati, 421-0329
Cleveland, 522-3037
Elsewhere,
1-800-554-4477

OKLAHOMA
1-800-554-4477

OREGON
Portland, 294-5363
Elsewhere,
1-800-554-4477

PENNSYLVANIA
Philadelphia, 592-8946
Pittsburgh, 261-1040
Elsewhere,
1-800-554-4477

PUERTO RICO
1-800-554-4477

RHODE ISLAND
1-800-554-4477

SOUTH CAROLINA
1-800-554-4477

SOUTH DAKOTA
1-800-554-4477

TENNESSEE
Nashville, 242-1541
Elsewhere,
1-800-554-4477

TEXAS
Dallas, 767-1792
Houston, 850-8801
Elsewhere,
1-800-554-4477

UTAH
1-800-554-4477

VERMONT
1-800-554-4477

VIRGINIA
Richmond, 829-6397
Elsewhere,
1-800-554-4477

WASHINGTON
Seattle, 343-7221
Elsewhere,
1-800-554-4477

WEST VIRGINIA
1-800-554-4477

WISCONSIN
Milwaukee, 291-1783
Elsewhere,
1-800-554-4477

WYOMING
1-800-554-4477

Tele-Tax Topic Numbers and Subjects

Topic No.	Subject
	IRS Procedures and Services
101	IRS help available—Volunteer tax assistance programs, toll-free telephone, walk-in assistance, and outreach program
102	Tax assistance for handicapped individuals and the deaf
103	Small business tax workshops—Tax help for new businesses
104	Problem resolution program—Special help for problem situations
105	Public libraries—Tax information tapes and reproducible tax forms
106	Examination procedures and how to prepare for an audit
107	The collection process
108	Tax fraud—How to report
109	Special enrollment examination to practice before IRS
110	Organizations—How to apply for exempt status
111	Audit appeal rights
112	Electronic filing
999	Local information
	Filing Requirements, Filing Status, Exemptions
151	Who must file?
152	Which form—1040, 1040A, or 1040EZ?
153	When, where, and how to file
154	What is your filing status?
155	Dependents
156	Estimated tax
157	Amended returns
158	Decedents
	Types of Income
201	Wages and salaries
202	Tips
203	Interest received
204	Dividends
205	Refund of state and local taxes
206	Alimony received
207	Business income
208	Sole proprietorship
209	Capital gains and losses
210	Pensions and annuities
211	Pensions—The general rule
212	Lump-sum distributions—Profit-sharing plans
213	Rental income and expenses
214	Renting vacation property/Renting to relatives
215	Royalties
216	Farming and fishing income
217	Earnings for clergy
218	Unemployment compensation
219	Gambling income and expenses
220	Bartering income
221	Scholarships, fellowships, and grants
222	Nontaxable income
223	Social security, tier 1, and catastrophic coverage
224	401(K) plans
225	Passive activities-Losses/Credits
	Adjustments to Income
251	Employee business expenses
252	Individual retirement arrangements (IRAs)
253	Alimony paid
254	Bad debt deduction
255	Tax shelters

Topic No.	Subject
	Itemized Deductions
301	Should I itemize?
302	Medical and dental expenses
303	Taxes
304	Moving expenses
305	Interest expense
306	Contributions
307	Casualty losses
308	Miscellaneous expenses
309	Business use of home
310	Business use of car
311	Business travel expenses
312	Business entertainment expenses
313	Educational expenses
	Tax Computation
351	Tax and credits figured by IRS
352	Self-employment tax
353	Five-year averaging for lump-sum distributions
354	Alternative minimum tax
355	Gift tax
356	Estate tax
357	Standard deduction
	Tax Credits
401	Child care credit
402	Earned income credit
403	Credit for the elderly or the disabled
	General Information
451	Substitute tax forms
452	Highlights of 1988 tax changes
453	Refunds—How long they should take
454	Copy of your tax return—How to get one
455	Forms/Publications—How to order
456	Tax shelter registration
457	Extensions for time to file your tax return
458	Form W-2—What to do if not received
459	Penalty for underpayment of estimated tax
460	Recordkeeping
461	How to choose a tax preparer
462	Failure to pay child/spousal support and other Federal obligations
463	Withholding on interest and dividends
464	Highway use tax
465	Checklist/Common errors when preparing your tax return
466	Withholding on pensions and annuities
467	Foreign currency transactions
	IRS Notices and Letters
501	Notices—What to do
502	Your tax form is overdue—Let us hear from you
503	Second request for information about your tax form
504	Notice of intent to levy
505	Notice of underreported income—CP2000
506	IRS notices and bills/Penalty and interest charges
	Basis of Assets, Depreciation, Sale of Assets
551	Sale of your home—General
552	Sale of your home—How to report gain
553	Sale of your home—Exclusion of gain, age 55 and over
554	Basis of assets
555	Depreciation
556	Installment sales

Topic No.	Subject
	Employer Tax Information
601	Social security withholding rates
602	Form W-2—Where, when and how to file
603	Form W-4—Employee's Withholding Allowance Certificate
604	Federal tax deposits—General
605	Employer identification number—How to apply
606	Form 942—Employer's Quarterly Tax Return for Household Employees
607	Form 941—Deposit requirements
608	Form 941—Employer's Quarterly Federal Tax Return
609	Form 940—Deposit requirements
610	Form 940—Employer's Annual Federal Unemployment Tax Return
611	Targeted jobs credit
612	Tips—Withholding and reporting
	Magnetic Media Information
651	Who must file originals and corrections?
652	Acceptable media/Locating a third party to prepare your files
653	Applications, forms, and information
654	Waivers, extensions, and format deviations
655	Test files and combined Federal/State filing
	Tax Information for Aliens and U.S. Citizens Living Abroad
701	Resident and nonresident aliens
702	Dual-status alien
703	Alien tax clearance
704	Foreign earned income exclusion—General
705	Foreign earned income exclusion—Who qualifies?
706	Foreign earned income exclusion—What income qualifies?
707	Foreign tax credit
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751	Who must file?
752	Which form to use?
753	What is your filing status?
754	Earned income credit
755	Highlights of 1988 tax changes
756	Forms and publications—How to order
757	Alien tax clearance
758	Refunds—How long they should take
759	IRS help available— Volunteer tax assistance programs, toll-free telephone, walk-in assistance, and outreach program
760	Social security, tier 1, and catastrophic coverage
	Tax Information for Puerto Rico Residents
851	Who must File a U.S. Income Tax Return in Puerto Rico
852	Deductions and Credits for Puerto Rico filers
853	Federal Employment Taxes in Puerto Rico
854	Tax Assistance For Residents of Puerto Rico

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530 ..... Tax Information for Homeowners
531 ..... Reporting Income From Tips
533 ..... Self-Employment Tax
534 ..... Depreciation
535 ..... Business Expenses
536 ..... Net Operating Losses
537 ..... Installment Sales
538 ..... Accounting Periods and Methods
539 ..... Employment Taxes
541 ..... Tax Information on Partnerships
542 ..... Tax Information on Corporations
544 ..... Sales and Other Dispositions of Assets
545 ..... Interest Expense
547 ..... Nonbusiness Disasters, Casualties, and Thefts
548 ..... Deduction for Bad Debts
549 ..... Condemnations and Business Casualties and Thefts
550 ..... Investment Income and Expenses
551 ..... Basis of Assets
552 ..... Recordkeeping for Individuals and a List of Tax Publications
554 ..... Tax Information for Older Americans
555 ..... Community Property and the Federal Income Tax
556 ..... Examination of Returns, Appeal Rights, and Claims for Refund
557 ..... Tax-Exempt Status for Your Organization
559 ..... Tax Information for Survivors, Executors, and Administrators
560 ..... Self-Employed Retirement Plans
561 ..... Determining the Value of Donated Property
564 ..... Mutual Fund Distributions
570 ..... Tax Guide for Individuals in U.S. Possessions
571 ..... Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations
572 ..... General Business Credit
575 ..... Pension and Annuity Income
583 ..... Information for Business Taxpayers
584 ..... Nonbusiness Disaster, Casualty, and Theft Loss Workbook
586A ..... The Collection Process (Income Tax Accounts)
587 ..... Business Use of Your Home
588 ..... Tax Information for Homeowners Associations
589 ..... Tax Information on S Corporations
590 ..... Individual Retirement Arrangements (IRAs)
593 ..... Tax Highlights for U.S. Citizens and Residents Going Abroad
596 ..... Earned Income Credit
597 ..... Information on the United States–Canada Income Tax Treaty
721 ..... Comprehensive Tax Guide to U.S. Civil Service Retirement Benefits
794 ..... Favorable Determination Letter
901 ..... U.S. Tax Treaties
904 ..... Interrelated Computations for Estate and Gift Taxes
907 ..... Tax Information for Handicapped and Disabled Individuals
908 ..... Bankruptcy and Other Debt Cancellation
909 ..... Alternative Minimum Tax for Individuals
911 ..... Tax Information for Direct Sellers
915 ..... Social Security Benefits and Equivalent Railroad Retirement Benefits
916 ..... Information Returns
917 ..... Business Use of a Car
919 ..... Is My Withholding Correct for 1989?
925 ..... Passive Activity and At-Risk Rules
926 ..... Employment Taxes for Household Employers
927 ..... Tax Obligations of Legalized Aliens
929 ..... Tax Rules for Children and Dependents
934 ..... Supplemental Medicare Premium
936 ..... Limits on Home Mortgage Interest Deduction
1167 ..... Substitute Printed, Computer-Prepared and Computer-Generated Tax Forms and Schedules
1212 ..... List of Original Issue Discount Instruments
1244 ..... Employee's Daily Record of Tips (Form 4070–A) and Employee's Report of Tips to Employer (Form 4070)

Spanish Language Publications

179 ..... Guía Contributiva Federal Para Patronos Puertorriqueños (Circular PR)
556S ..... Revisión de las Declaraciones de Impuesto, Derecho de Apelación y Reclamaciones de Reembolsos
579S ..... Cómo Preparar la Declaración de Impuesto Federal
586S ..... Proceso de Cobro (Deudas del Impuesto Sobre Ingreso)
850 ..... English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
927 ..... Obligaciones Tributarias de los Extranjeros con Estado Legalizado

*U.S. G.P.O. 1988-203-865

How to Get IRS Forms and Publications

You can order tax forms and publications from the IRS Forms Distribution Center for your state at the address below. Or, if you prefer, you can photocopy tax forms from reproducible copies kept at many participating public libraries. In addition, many of these libraries have reference sets of IRS publications which you can read or copy.

If you are located in:	**Send to "Forms Distribution Center" for your state**
Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, Wyoming	Rancho Cordova, Ca. 95743-0001
Alabama, Arkansas, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Nebraska, North Dakota, Ohio, Oklahoma, South Dakota, Tennessee, Texas, Wisconsin	P.O. Box 9903, Bloomington, IL 61799
Connecticut, Delaware, District of Columbia, Florida, Georgia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia	P.O. Box 25866, Richmond, VA 23289

Foreign Addresses—Taxpayers with mailing addresses in foreign countries should send their requests for forms and publications to: Forms Distribution Center, P.O. Box 25866, Richmond, VA 23289; Forms Distribution Center, Rancho Cordova, Ca. 95743-0001, whichever is closer.

Puerto Rico—Forms Distribution Center, P. O. Box 25866, Richmond, VA 23289

Virgin Islands—V.I. Bureau of Internal Revenue, Lockharts Garden, No. 1A, Charlotte Amalie, St.Thomas, VI 00802

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Order blank—We will send you 2 copies of each form and 1 copy of each set of instructions or publication you circle. Please cut the order blank on the dotted line above and **be sure to print or type your name and address accurately on the bottom portion.** This will be the label used to return material to you. Enclose this order blank in your own envelope and address your envelope to the IRS address shown above for your state. To help reduce waste, please order only the forms, instructions, and publications you think you will need to prepare your return. Use the blank spaces to order items not listed. If you need more space, attach a separate sheet of paper listing the additional forms and publications you may need. Be sure to allow 2 weeks to receive your order.

1040	Schedule C (1040)	2106 & Instructions	4868	Pub. 463	Pub. 523	Pub. 554	
Instructions for 1040 & Schedules	Schedule D (1040)	2119 & Instructions	8283 & Instructions	Pub. 501	Pub. 524	Pub. 910	
1040A	Schedule E (1040)	2210 & Instructions	8332	Pub. 502	Pub. 525	Pub. 917	
1040EZ	Schedule F (1040)	2441	8582 & Instructions	Pub. 504	Pub. 527	Pub. 929	
1040A & 1040EZ Instructions	Schedule R (1040) & Instructions	3468 & Instructions	8606	Pub. 505	Pub. 529		
1040X & Instructions	Schedule SE (1040)	3903 & Instructions	8615	Pub. 508	Pub. 545		
Schedules A&B (1040)	1040-ES (1989)	4562 & Instructions	Pub. 17	Pub. 521	Pub. 553		

Internal Revenue Service

17

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From the Executive Office of the President

Office of Management and Budget

Introduction

Each January the President is required to submit to the Congress his budget proposal for the upcoming fiscal year. The budget sets forth the President's proposed financial plan of operation for the federal government. The plan includes recommendations for new legislative proposals as well as recommendations to change or maintain existing activities.

The Congress can change, eliminate, and add programs to the President's budget. The Congress enacts many separate spending and revenue bills. In addition, the Congress enacts resolutions setting ceilings or targets for total spending and a floor for total receipts.

Fiscal Year 1988 Budget

Preliminary data for fiscal year 1988 (which began on October 1, 1987, and ended on September 30, 1988), show that federal outlays were $1,064.1 billion, and receipts were $909.0 billion, leaving a deficit of $155.1 billion.

The budget deficit is financed largely by government borrowing from the public. The government borrows from the public by selling bonds and other debt securities to private citizens, banks, and other businesses.

Your Government Dollar

Income and social insurance taxes are, by far, the largest sources of federal receipts. In 1988, individuals paid $401.2 billion in income taxes and corporations paid $94.2 billion in corporation income taxes. Social security and other insurance and retirement taxes and contributions were $334.3 billion. Excise taxes accounted for $35.5 billion of receipts and the remaining $43.7 billion was accounted for by Federal Reserve deposits, custom duties, estate and gift taxes, and other miscellaneous receipts.

Government receipts provide a wide range of public services. The following is a breakdown of how the federal dollar was spent in 1988.

National defense: $290.3 billion. The federal government spent 27 cents of each dollar to equip and modernize our armed forces, pay salaries of military personnel, and for defense-related atomic energy activities.

International affairs: $10.5 billion. About 1 cent of each federal dollar was spent to provide economic, military, and technical assistance to other nations, to fund the administration of foreign affairs and international organizations, and to maintain foreign exchange and information programs abroad.

General science and space: $10.9 billion. About 1 cent of each dollar was spent to expand scientific knowledge through general science and basic research, including space exploration, and to develop worthwhile uses of space technology.

Energy: $2.3 billion. About ¼ cent of every dollar was spent to support the development of domestic energy supplies, to improve energy conservation, and to promote energy research and information programs.

Natural resources and environment: $14.5 billion. Programs to control pollution, develop water resources, and to maintain and conserve public lands and recreation areas claimed 1½ cents of each federal dollar.

Agriculture: $17.2 billion. About 1½ cents of every dollar was spent to stabilize farm income, encourage agricultural research, products, and to prevent the introduction and spread of plant and animal pests and diseases.

Commerce and housing credit: $19.1 billion. Nearly 2 cents of each federal dollar was spent to ensure an adequate supply of mortgage credit, provide the federal payment to the Postal Service, and provide oversight and assistance to small businesses.

Transportation: $27.3 billion. The federal government provides grants to state and local governments for highways, mass transit, and airports. In addition, the federal government maintains the Coast Guard, regulates federal airways, and provides financial assistance to railroads and shipping. These programs claimed 2½ cents of each dollar in 1988.

Community and regional development: $5.6 billion. The federal government provides grants and loans to develop urban and rural areas and to provide relief and insurance to victims of natural disasters. These programs claimed about ½ cent of each dollar in 1988.

Education, training, employment, and social services: $30.9 billion. In 1988, nearly 3 cents of each dollar went for grants to elementary, secondary, and vocational education and aid to college students, training and employment services, and grants to states for social services.

Health: $44.5 billion. The federal government spent over 4 cents of every federal dollar on health programs, not including Medicare and veterans health programs. These programs comprise medicaid, training and research, and consumer and worker safety.

Medicare: $78.8 billion. Nearly 7½ cents of the federal dollar was spent for the Medicare program, primarily for the benefit of the aged.

Income security: $130.2 billion. Programs in this category include retirement and disability benefits (other than social security), unemployment compensation, and other programs such as food stamps, cash benefits and housing assistance. These programs claimed 12¼ cents of every federal dollar.

Social security: $219.0 billion. In 1988, social security claimed 20½ cents of each budget dollar. Outlays for social security go to the old age and survivors insurance (OASI) and the disability insurance (DI) programs.

Veterans benefits and services: $29.3 billion. Veterans programs provide income to veterans and their families, medical services, education and training, and life insurance programs. Outlays for veterans programs claimed about 2¾ cents of each dollar in 1988.

Administration of justice: $9.2 billion. Enforcing federal laws, providing detention and correctional facilities for people charged with or convicted of violating federal laws, and providing financial support for state and local government criminal justice systems claimed about 1 cent of every federal dollar spent in 1988.

General government: $9.5 billion. The activities of the executive and legislative branches, managing government finances and internal government services, and financial aid to state and local governments claimed about 1 cent of each dollar.

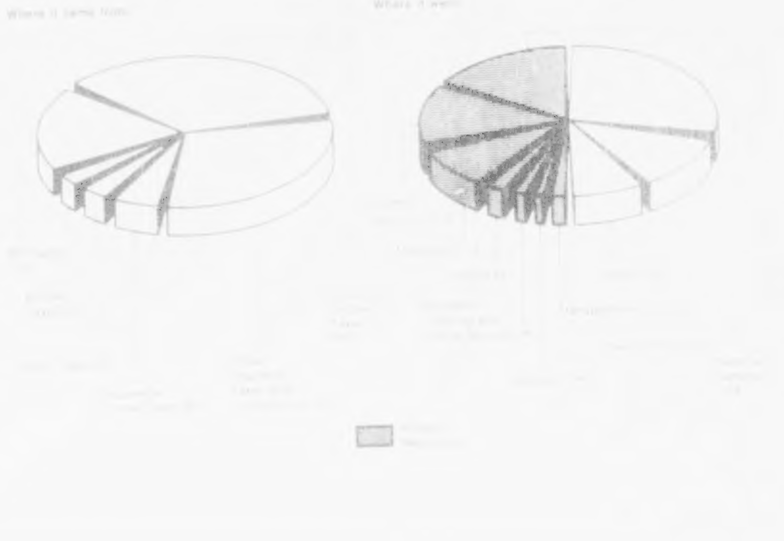
Net interest: $151.7 billion. Interest payments on the public debt less the portion paid to trust funds and other interest received took 14¼ cents of each dollar.

Undistributed offsetting receipts: ($36.6) billion. These offsetting collections are primarily for rents and royalties on the Outer Continental Shelf and the employer share of employee retirement.

Note: Detail may not add to totals due to rounding.

Fiscal Year 1988

The Government Dollar



Where to File

If an addressed envelope came with your return, please use it. If you do not have one, or if you moved during the year, mail your return to the **Internal Revenue Service Center** for the place where you live. No street address is needed.

If you are located in:	Use this address:
Florida, Georgia, South Carolina	Atlanta, GA 39901
New Jersey, New York (New York City and counties of Nassau, Rockland, Suffolk, and Westchester)	Holtsville, NY 00501
Connecticut, Maine, Massachusetts, New Hampshire, New York (all other counties), Rhode Island, Vermont	Andover, MA 05501
Illinois, Iowa, Minnesota, Missouri, Wisconsin	Kansas City, MO 64999
Delaware, District of Columbia, Maryland, Pennsylvania, Virginia	Philadelphia, PA 19255
Indiana, Kentucky, Michigan, Ohio, West Virginia	Cincinnati, OH 45999
Kansas, New Mexico, Oklahoma, Texas	Austin, TX 73301
Alaska, Arizona, California (counties of Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Mendocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo, and Yuba), Colorado, Idaho, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming	Ogden, UT 84201
California (all other counties), Hawaii	Fresno, CA 93888
Alabama, Arkansas, Louisiana, Mississippi, North Carolina, Tennessee	Memphis, TN 37501
American Samoa	Philadelphia, PA 19255
Guam	Commissioner of Taxes Agana, GU 96910
Puerto Rico *(or if excluding income under section 933)*	Philadelphia, PA 19255
Virgin Islands: Non-permanent residents	Philadelphia, PA 19255
Virgin Islands: Permanent residents	Bureau of Internal Revenue Lockharts Garden No. 1A Charlotte Amalie St. Thomas, VI 00802
Foreign Country: *U.S. citizens and those filing Form 2555 or Form 4563, even if you have an A.P.O. or F.P.O. address*	Philadelphia, PA 19255
A.P.O. or F.P.O. *address of:* Miami New York San Francisco Seattle	 Atlanta, GA 39901 Holtsville, NY 00501 Fresno, CA 93888 Ogden, UT 84201

Internal Revenue Service
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